CORPORATE STRATEGY FOR A SUSTAINABLE GROWTH

Alignment, Execution, and Transformation

Guido Corbetta
Paolo Morosetti

BUP

Corporate strategy differs from business strategy by the fact that the former aims at building a corporate advantage, while the latter a competitive advantage. Both are intertwined and are crafted not only to find an alignment with the environmental context and company's resources, but also with the ownership model. Two are the main groups of decisions that characterize corporate strategy: Where to invest or divest? How to manage the business portfolio?

This book, rooted in academic research, the teaching experiences of the authors, and their direct understanding of the corporate world, consists of seventeen chapters, which allow readers to learn how to analyze and evaluate a corporate strategy; how to make and implement growth or divestiture decisions; how to manage M&A processes; how to design the organizational structure to translate a portfolio strategy into sound results; how to implement an effective corporate governance, and how to guide a strategic and organizational change.

Written for students, managers, entrepreneurs, owners, board members, and advisors, this book provides concepts, methods and practices to make good corporate strategy decisions in firms of any size, whose boundaries can cross multiples industries and geographies.

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Introduction

We decided to write this book with three goals in mind:

- To reflect on how to make good corporate strategy decisions, building on sound theoretical contributions.
- To broaden the awareness of the importance of such decisions for the sustainability of firms of any size.
- To help firms thrive and transform through the implementation of new corporate strategy models, rather than only through new business models.

We distinguish corporate strategy from business strategy by the fact that the former represents a system of decisions and actions aimed at building a sustainable corporate advantage, while the latter represents a system of decisions and actions aimed at building a sustainable competitive advantage.

This distinction marks a difference that is worth noting: a corporate strategy is focused on the entire firm – the multi-business firm – while a business strategy is focused on a single business. Therefore, there are two levels in strategic decision-making with the corporate one placed hierarchically higher than the business one. Of course, there are strong interrelationships between them and, in order to achieve excellent performance, both strategies must dialogue, as will be explained in the course of this book.

Corporate strategy decisions are divided into portfolio strategy and parenting strategy decisions. Dealing with portfolio strategies allows to choose the businesses in which to invest, the new businesses in which to enter, and the businesses from which to totally or partially divest. Dealing with a parenting strategy allows to decide the corporate governance model, the fundamental organizational choices, the role of the corporate headquarters and how they operate, and the leadership system.

This book has been written for various readers:

- Entrepreneurs who are motivated to promote the firm's growth in the long term.
- Corporate strategists – leaders and top managers – who want to diversify and internationalize the firm where they are working.
- Members of boards of directors who are keen to contribute to the strategy process.
- Owners who would like to play their role in an active and responsible way.
- Consultants who assist firms in formulating and carrying out corporate strategy decisions.
- Financial analysts whose job is to value firms and give recommendations to buy or sell their shares.
- Students in undergraduate, graduate, post-graduate and specialization courses, such as MBAs and Executive MBAs.

On a theoretical level, our thinking is placed in the domain that investigates how to make and implement good strategic decisions. On that regard, we are thankful to those who have developed remarkable theories we have broadly employed in writing this book, such as the profit – maximizing and competition – based theory, the resource-based view, the transaction cost theory, the stakeholder theory, the contingency theory, and agency cost theory.

We have also tried to introduce some new elements to the debate in this field. In a nutshell, such new elements can be summarized as follows:

1. We developed a model for evaluating and appraising corporate strategy decisions that integrates the financial dimension with the environmental and social ones. We don't believe that decisions of this nature can be taken just by considering a "single number" as the shareholder value approach suggests. They must be rooted in a multidimensional approach and must be contextualized in broad time horizons. In other words, it not enough to make profit, it is also important *how* to make profit.

2. We attributed a relevant importance to growth decisions in our thinking, because too many firms have huge untapped growth potential to leverage and drive success.
3. We considered the interplay between corporate strategy, ownership, and corporate governance. In firms with “strong ownership,” such as family-owned firms, corporate strategy decisions can be influenced by the activism of vocal owners. In firms with “weak ownership,” such as public firms, the board plays a crucial role in providing strategic guidance and monitoring the leadership and top management. In addition, an effective governance prevents some people from extracting individual benefits or perks instead of working to maximize the firm’s interests.
4. We developed an overall approach to corporate strategy that marries the importance of making good decisions with the importance of their careful execution.

How the book is organized

The book is divided into seventeen chapters. Chapter 1 illustrates the concept of corporate strategy and the method to evaluate this kind of decisions, i.e. whether or not they are able to build a corporate advantage. We distinguish two approaches in making corporate strategy decisions: the synergy approach and the financial approach. They represent the two opposite ends of a continuum.

Chapter 2 explains portfolio matrices: a managerial tool to analyze the effectiveness of corporate strategy decisions, and to assess alternative actions to be taken in the future.

Chapter 3 investigates the concept of corporate social responsibility and how it can be gradually integrated into a corporate strategy.

Chapter 4 clarifies what synergy means by distinguishing between financial and operational synergies. In addition, it introduces the concept of corporate valuable resources understood as drivers of a corporate advantage.

Chapter 5 analyzes the theme of core business: how to identify it and what are the managerial implications for those who lead the firm.

Chapters 6 to 12 are dedicated to portfolio strategy decisions. In particular, Chapter 6 sheds light on the notions of scale, corporate scope and growth decisions. Chapter 7 delves into growth strategies with a synergy approach, while Chapter 8 digs into the peculiarities of growth strategies with a financial approach. As growth strategy is all about diversification, this chapter also provides some reflections on the relationship between diversification and performance.

Chapter 9 discusses the modes of growth: internal development, alliances, or mergers and acquisitions. We outline the respective advantages and disadvantages and two models that can be used to choose the best option in a given context.

Chapter 10 develops the theme of Mergers and Acquisitions (M&As), proposing a model to manage the M&As process, with particular attention paid to the phase of integration.

Chapter 11 deals with equity and non-equity alliances, providing insights into how to classify them and successfully manage the collaborative relationships between partners that may be in competition.

Chapter 12 looks at the internationalization strategies, starting from the assumption that they partially overlap with corporate strategy.

Chapters 13 to 16 examine parenting strategy decisions. Notably, Chapter 13 explains the different ownership structures by which a firm can be controlled, the role they play in strategic processes based on the distinction between strong and weak ownership, and best practices to design and lead a board of directors.

Chapter 14 reflects on the role and functioning of corporate headquarters: an issue we deem crucial and on which we invite midsize firms to invest resources, especially those with ambitious growth goals in terms of diversification, internationalization, and vertical integration.

Chapter 15 is dedicated to organizational choices, in particular those concerning the organizational structure of the multi-business firm.

Chapter 16 tackles the challenge of leadership by proposing various interpretations of its components and sources of authority. A specific discussion is also devoted to the negative leadership syndrome, which unfortunately is not so rare.

Lastly, Chapter 17 examines the process of strategic and organizational change, focusing on the causes that trigger it, the approach through which it can be guided, and the resistance or barriers to change that can be encountered along the way.

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Special thanks go to our publisher, in the person of Orsola Matrisciano, who first prompted us to print this book in Italian, and then to translate and enrich it for an English version.

To conclude, we look at this work as one stage of our learning journey on corporate strategy. On the one hand, academic research goes forward, and we will follow the developments to keep this book up-to-date. On the other, in a constantly and rapidly evolving world, strategic thinking must evolve to codify new developments underway. This last point brings us to a question that our parents, spouses, and children asked so many times: "When will the book be done?" The answer is simple: "Never!" We hope to *never* stop exploring and learning. And we wish for our readers to never stop exploring and learning too!

Guido Corbetta
Paolo Morosetti

1 Corporate Strategy

by *Guido Corbetta*

1.1 From competitive strategy to corporate strategy decisions

To explore the difference between *competitive strategy* and *corporate strategy* – and thus, between the competitive advantage necessary to prosper within a business and the corporate advantage necessary to create value for the multibusiness firm – it is useful to reflect on the case of the Fiat Chrysler Automobiles group (FCA).

In 2014, the group owned different product brands such as: Panda, 500, Jeep, Ferrari, Maserati, and Alfa Romeo. In the economy car business (like the "Panda") the group was making decisions in terms of products, technologies, and distribution channels entirely different than those necessary to successfully compete in the luxury car business (Ferrari brand).[1] Differences in the strategy were also present between the economy car business and the urban car business in which the group competed with the 500 brand; or between the business of luxury cars in which Ferrari was active, and that of premium vehicles occupied by Maserati or Alfa Romeo cars. One of the main drivers to justify different competitive strategies was that in each business the competition dynamics and competitors were unlike. Continuing the analysis, we could ask if Jeep was in the same business as Maserati and Alfa Romeo, or in a separate one. We could also ask if the North American market – due to its characteristics in terms of product configuration, consumer behavior, distribution channels, and so forth – represented a different business than that of Europe or South America. If so, then we could distinguish between a U.S. urban car business and a Europe urban car business.

Beyond the problem of determining in how many and which businesses the FCA group was present in 2014, it is a matter of fact that it operated in more than one, and was a multibusiness firm. As a consequence, the leadership was facing two kinds of questions:

1. *Competitive strategy questions*: How is it possible to build and maintain a competitive advantage in each business? What choices regarding products, technologies, distribution channels, pricing, promotion, and so forth are recommended in each of them?
2. *Corporate strategy questions*: Are there advantages in being present in all businesses or could it be more convenient to compete in only some of them? If it were deemed not convenient to be present in all, how to exit one or more? Could it be useful to enter a new and related industry, as Audi did in 2012 when it acquired the control of Ducati (motorcycle business)? Having a certain amount of resources available at the corporate level, how should those resources be allocated between the various businesses? From an organizational standpoint, how should the presence in the various businesses be coordinated? Which decisions should be made by the leadership at corporate level and which by the leadership of each specific business?

Competitive strategy decisions are different from corporate strategy decisions in firms of any size. Recognizing such a difference is the first step toward making good strategic choices.

1.2 Corporate strategy in the literature

In the literature, many definitions of corporate strategy have been developed that differ on two main factors: the contents of the corporate strategy decisions, and the perspective of analysis.[2] In this section we discuss three of them. The third is the one we have taken as a reference in this book.

The Interest Group that deals with corporate strategy at the Strategic Management Society defines this concept as follows: decisions, actions and outcomes associated with an organization's portfolio of business lines.

> The research and practice of corporate strategy considers actions associated with changing the firm's scope and profile of business lines including vertical integration, mergers and acquisitions, divestitures, corporate diversification strategy/organization, implementation and performance. Recent research considers how resources shape a firm's scope and relatedness of business lines, how firm resource composition influences merger and acquisition outcomes, how diversified firms are managed most effectively and why and when divestiture becomes viable. Other areas of interest include how a firm's resources impact its growth and divestment decisions, when different modes of growth and reduction are used, and what tradeoffs exist among various types of diversification strategies and its organization alternatives. Corporate strategy draws from a wide range of theories and methods to help explain the determinants and performance outcomes of managing the scope and boundaries of the diversified firm.[3]

This definition sheds light on an essential tenet: a strategy at the corporate level exists when the firm operates in multiple businesses ("business lines" in the quote above). But what is a business? There are three different ways of defining it.

First, businesses can be identified by leveraging the concept of *business model*. A business model consists of choices relating to three elements: customers (who), products (what), and the value chain (how). Two businesses are different if at least one of the three elements of the business model is different than that of the other businesses in the portfolio.[4]

Second, other scholars suggest an alternative approach, which is made up of the following steps:

- Create a matrix of the product/market combinations in which a firm operates (markets understood as customer groups or geographic areas).
- Determine the differences/similarities that characterize each product/market combination.
- Assess the relative importance of those differences/similarities.
- Identify two different businesses, if significant differences exist between one product/market combination (or a set of combinations)

and others, and when there are different competitors.[5]

Third, in practice, leadership defines businesses neither in a single way nor accepting a unique definition. Rather than dedicating time to theoretically "resolving" the issue, they usually adopt an incremental and iterative approach. In other words, an attempt is made to give an initial definition to the businesses, then it is required to see if such a definition allows for understanding the situation, and if the first definition is not satisfactory, a different one is attempted.

The process of defining the businesses does not lead to right or wrong results, but to useful or useless results depending on the type of problem or analysis that the leadership is carrying out. Such a process is subjective and contextual as Campbell et al. recognize:

> How should the business be segmented? […] The answer is that it is normally useful to use […] multiple levels of analysis. Typically, you start at a high level, to provide an overall diagnostic. You then "unpeel the onion" by segmenting down to finer levels of detail in order to focus on particular choices that have to be made.[6]

As for the variety of corporate strategy decisions, the Strategic Management Society's definition of Interest Group distinguishes them into two categories:

- A change to the portfolio of the businesses in which a firm competes and the methods of entering (or exiting) a business.
- The management of a multibusiness firm, and more in general, the actions for implementing corporate strategy.

It is worth noting that the Interest Group also emphasizes the importance of firm resources in making choices as well as in crafting any strategies.[7]

Another well-known definition of corporate strategy has been formed by Collis et al. A corporate strategy is understood as "the path along which a firm attempts to create value through the configuration and coordination of its multimarket activities."[8]

This definition confirms the distinction between competitive strategy and corporate strategy. While the first deals with studying the customer/channel/product/technology choices aimed at reaching and maintaining a competitive advantage in the context of a *single* business (understood here as a synonym of the term “market” used by Collis et al.), corporate strategy involves choices by firms that operate in multiple businesses aimed at reaching and maintaining a corporate advantage, and as a consequence, creating value. Those choices regard:

- The *configuration* of the portfolio, the business mix in which the firm is present (or corporate scope),[9] or the decisions regarding whether or not to enter (or exit) a new business, what methods to use to enter (or exit) a business, which and how many resources to invest in the businesses in which a firm is present.
- The *coordination* of the portfolio, the decisions concerning the design and the management of the firm’s organizational units. When a firm is present in multiple businesses, at least two organizational levels are generally created: a first one dedicated to managing the single business units,[10] and a second to coordinating those different units.[11] Coordination regards all of the possible interactions between units placed at two organizational levels and among the units placed at the same level.[12]

Finally, Campbell et al. state that the path along which a multibusiness firm attempts to create value is divided into two main components:

> corporate level strategy involves making decisions about which businesses to own and invest in (portfolio strategy) and how to manage or parent the businesses (management/parenting strategy).[13]

It is not difficult to recognize the similarity between the last two definitions proposed. Both consider two areas of work: the configuration of the portfolio, or portfolio strategy, and the coordination of the portfolio, or parenting strategy. The principal differences between the two approaches concern the conceptual framework to make decisions. Whereas Collis et al. propose dividing the elements of corporate strategy into a “triangle” made up of resources, businesses, and organization, and making decisions considering the quality of the single elements and the alignment of those elements with each other and with the external context, Campbell et al. suggest adopting four logics to make corporate strategy choices:

1. *Business logic.* Are the markets/industries in which each business competes very or scarcely attractive? In those markets/industries, does each business have a competitive advantage or not?
2. *Added value logic.* Are the corporate-level managers (or corporate headquarters) able or not able to add value to a business?
3. *Capital markets logic*. Does the performance of capital markets or other situations make the market price for a business lower or higher than its fair value?[14]
4. *Governance and compliance logic*. Which activities should the firm carry out at corporate level to be compliant with regulations or specific stakeholders’ requests? How to organize the corporate governance model taking account of legal prescriptions and international best practices?

The first three logics provide elements useful to evaluate the configuration of a business portfolio. If a business, despite the added value produced by the corporate headquarters, can be sold at a higher price than its fair value, then according to the capital markets logic, it should be sold. If a business can be bought only for a higher price than its fair value (capital markets logic), the leadership should make that decision only if it thinks it can add value to the business once bought (added value logic). If a business operates in an unattractive industry or is unprofitable (business logic), it should be sold, unless the leadership believes it can add value by exploiting synergy (added value logic) or unless its market value is so low as to make it entirely inconvenient to sell (capital markets logic).

The application of the three logics clearly requires detailed work and experience, but the awareness of their simultaneous relevance represents *per se* a key learning point for all corporate strategists.

Going deeper into the details of the framework proposed by Campbell et al., portfolio strategy decisions are divided into:

- Decisions to invest in the existing portfolio.

- Decisions to enter new businesses that are close or far from those already covered.
- Decisions to partially or totally divest from one or more businesses.

Such decisions impact the corporate scope and should be made weighing the firm's resources and the evolution of the industries and geographies in which the businesses compete. The selection of the modes of growth (internal development, equity or non-equity alliances, acquisitions, mergers) and those of divestiture (sell-offs, spin-offs, split-ups, equity carve outs, or closing of activities) is still part of the portfolio strategy domain.

Once the configuration of the portfolio has been decided on, the leadership must examine how the entire firm and the various businesses can be organized and managed. Those choices correspond to what Campbell et al. call parenting strategy, and regard four elements:

1. *Corporate governance*. In particular, the design of an effective Board of Directors (BoDs) represents a very delicate choice to make. Various theories and practices have been developed to help firms choose the most appropriate role, composition, structure and functioning of their BoDs.[15]
2. *Organizational choices*. These regard: (i) *culture*, intended as "a pattern of basic assumptions, invented, discovered, or developed by a given group, as it learns to cope with its problems of external adaptation and internal integration;"[16] (ii) *structure,* intended as the division of the organization into distinct sub-units that benefit from a certain degree of independence and are linked to each other by hierarchical relationships; (iii) *systems*, i.e., the sum of formal policies and routines that guide organizational choices; (iv) *processes*, i.e., "how" a firm's activities are concretely carried out. All of the organizational choices must be consistent with each other and aligned with the portfolio configuration.
3. *Role and organization of the corporate headquarters.* The corporate headquarters plays different roles within the organization depending on the type of hierarchical relationships it creates with other organizational units, and on the way it sets up relationships between the various organizational units at the business level.

4. *Leadership.* The success of a firm depends to a certain extent on the quality of those that lead it, in the roles of chairman, CEO and/or managing director, and first-level managers (the top management). In a corporate strategy perspective, reflecting on the characteristics of a good leader is essential to understand if and how such people can make good decisions and then implement them.

As for the relations between corporate headquarters and organizational units dedicated to the single businesses, Campbell et al. argue that added value is the main logic orienting parenting strategy decisions. In other words, such decisions should be guided by the goals of maximizing added value in coordinating and controlling different businesses, and of minimizing all of the negative aspects due to the creation of organizational mechanisms to manage the multibusiness dimension.

Governance and compliance logic also helps make parenting strategy decisions. For example, the corporate headquarters, must be well designed and managed to interact with ownership and other stakeholders, comply with regulations, draw up strategic plans to submit to the BoD, and appoint the management of subsidiaries.

Finally, recent research has demonstrated that corporate strategy choices are influenced by the ownership structure.[17] The risk-return expectations of the owners and resources made available by them for growth are elements that the corporate bodies and the leadership must contemplate in defining future strategies.

1.3 Two approaches to corporate strategy

There are two different approaches to corporate strategy that can be adopted by firms: the synergy approach and the financial approach.

1. The *synergy approach* is characterized by:
   - a conception of the firm that above all stresses the importance of managing a portfolio of common resources (tangible assets, intangible assets, and organizational competences) and promoting mainly operational synergies among the various businesses by the corporate headquarters;

- a competitive strategy for each business that exploits the relationships between the businesses in the portfolio.

2. The *financial* approach is characterized by:
   - a conception of the firm that above all stresses the importance of managing financial synergies among businesses by the corporate headquarters;
   - a competitive strategy for each business that considers it independently of the others.

No approach is better than the other. They represent two opposite sides of a continuum line that encompasses a wide range of strategies a firm can pursue.

1.4 Six portfolio strategy models

Using three dimensions – the presence of businesses in the same industry or in different industries, the geographic scope of the firm, and the similarity/difference of the resources necessary to be successful in a certain business – six different portfolio strategy models can be identified.[18]

1. *Single industry, domestic*. The firm competes in multiple businesses in a single industry and with a geographical scope limited exclusively (or almost exclusively) to the domestic market. This model includes, for example, some Italian banks operating only in Italy in commercial banking and private banking. This model is based on in-depth knowledge of the domestic market, and is generally the simplest from an organizational standpoint.
2. *Single industry, multinational*. This strategy differs from the previous one only due the geographic scope: multinational, rather than domestic. Think of the case of Frescobaldi, the well-known firm operating globally in the luxury wine business, premium wines, and sparkling wines, which exports more than 60 percent of the total revenues. This model is more complex to implement than the previous one, because it implies some knowledge of diverse geographic markets

and requires organizational solutions that take into account a presence in some of them.

3. *Multi-industry, technology-driven*. The firm competes in different industries and benefits from operational synergies mainly due to a transfer or share of resources related to technology. SOL is a listed company on the Milan Stock Exchange that operates in the industry of gas for industrial production and gas for health care uses (for example, home oxygen). This group uses the technology for production and processing of gas for competing in both businesses.
4. *Multi-industry, marketing-driven*. The firm operates in different industries, with a geographic scope of any type, and where operational synergies in marketing and sales represent a key driver for building the corporate advantage. This model has been adopted by many large consumer goods companies such as Procter&Gamble and Unilever, but also by smaller players such as Sammontana, which is specialized in three businesses: ice cream (with the *Sammontana* brand), frozen pastries (with the Mongelo brand), and baked goods (with the *Tre Marie* brand).[19]
5. *Conglomerate with a main business*. In the conglomerate model, the firm is present in many industries and is committed to exploiting mainly financial synergies. The main business represents the most important part of revenues and value for the group. It might be possible that corporate headquarters is also engaged in finding ways to transfer or share other resources among businesses, but this regards support activities in the value chain.[20] This model has been adopted by the De Agostini group. Although the group is present in television communication, publishing, and private equity investment, today the vast majority of its value derives from the investment in IGT, a firm listed on Wall Street operating in the gaming sector. It is interesting to note that this model is sometimes an intermediate step for groups that are changing from multi-industry to conglomerate, while in other cases it is a change from the model of the classic conglomerate, when one business takes hold as the most interesting one in terms of creation of value.
6. *Classic conglomerate*. The firm has invested in very diverse industries, none of which takes on a predominant role within the group. Edizione group, controlled by the Benetton family, is a clear example of this

model. The group competes in very different industries not related each other, such as fast fashion, highways, restaurants, airports, and agriculture.

The first four models belong to the synergy approach, while the last two models to the financial approach. The classification of a firm in one of these models requires an in-depth analysis, especially to distinguish between models that appear to have overlapping characteristics. Furthermore, each firm evolves over time, and thus each classification decision must be anchored in time.

1.5 Four parenting strategy models

Building on a well-known contribution by Porter,[21] four parenting strategy models can be identified.

1. *Transferring competences*. The corporate headquarters distributes an organizational competence (marketing, production, research, and so on) to two or more businesses and/or promotes its transfer from one business to another, with the aim of increasing the competitiveness of the firm in each business. In the case of the synergy approach, the transfer of competences can regard both primary and support activities in the value chain. In the case of the financial approach, the transfer principally regards support activities, in particular infrastructure activities and human resources management.
2. *Sharing assets* (tangible and intangible). The corporate headquarters promotes the sharing of one or more tangible or intangible assets to exploit economies of scale, scope, or experience at the corporate or business level. In the synergy approach, sharing assets regards primary and support activities of the value chain, while in the financial approach it mainly concerns support activities, in particular infrastructure activities and human resources management.
3. *Dynamic portfolio management*. The corporate headquarters creates value by buying undervalued firms (or business lines) or selling parts of the portfolio at a price higher than the fair value. Dynamic portfolio

management applies principally in firms with a financial approach but can also be adopted by firms with a synergy approach.

4. *Restructuring*. The corporate headquarters intervenes on businesses not performing well to restore competitiveness swiftly by changing the competitive strategy, or the leadership. The restructuring can be adopted with both a synergy and financial approach.

Provided that a firm can put in place more than one model simultaneously, their adoption implies precise choices in terms of governance, culture, organizational structures, operating systems, role and functioning of the same corporate headquarters.

1.6 The evaluation of corporate strategy

No corporate strategy model can be defined *a priori* as more successful than others. In terms of portfolio strategy there is no incontestable scientific evidence in favor of a single industry domestic model, for example, nor is there evidence in favor of multi-industry technology-driven or multi-industry marketing-driven models, or the conglomerate model (although there are certainly many cases of conglomerates created with the primary goal of increasing the power of single shareholders or managers rather than maximizing the firm's value). In the same way, there is no definitive evidence demonstrating that the synergy approach is *always* superior to the financial approach.

That said, to evaluate a corporate strategy, it is useful to first conduct a *synthetic evaluation* in financial terms through two complementary logics.[22]

- *Accounting logic*. The judgment is based on the analysis of the well-known ratios of profitability (that allow for measuring the return for shareholders), growth (aimed at measuring the competitiveness of the various businesses), solidity (aimed at measuring the degree of financial risk), and liquidity (aimed at measuring financial flexibility).
- *Value logic*. The judgment is focused on the ability of the firm to create value. The measurement can be made by comparing the return on equity (ROE) with the expected return with investments of equal

risk (expressed as cost of equity, Ke). The first should be persistently higher than the second over time. In the case of listed firms, it is also useful to observe the performance of the stock and to calculate the Total Return for Shareholders (TRS). Such measures have to be compared with those of a group of peers to formulate proper judgments.[23]

Any evaluation must be carried out paying attention to:

- *Time delays*. A corporate strategy could require time to be fully implemented and deliver interesting returns. Sometimes, it is necessary to wait even years before its effects can be fully felt.
- *Comparisons over time.* Any evaluation should always consider an adequate time horizon. Given that the horizon depends on the businesses considered, a minimum time frame of three to five years is usually recommended.
- *Comparison with competitors*. Every evaluation must always include a benchmark with competitors pursuing a similar corporate strategy. This is actually quite difficult, since it is not easy to identify two corporate strategies that are identical. Nevertheless, even a comparison with firms following similar strategies could be useful to develop a strong opinion.

The results of the synthetic analysis lead to a judgment that can be further elaborated by applying the logics proposed by Campbell et al.[24] In this way, a detailed analysis based on five elements (that we could call the "evaluation diamond") can be carried out.

- *The "better-off test" (BOT)*. This test is useful to understand if a business creates greater value within the firm portfolio with respect to its stand-alone management and ownership. To concretely apply this test it is indispensable to have information on the competitive and financial performance of a firm active only in that specific business, and to compare it with the performance of the business located in the multibusiness firm whose corporate strategy is being evaluated.[25]
- *The "best-alternative test" (BAT)*. This test leads to considering not only the comparison between the performance of the business in the

firm portfolio or the stand-alone alternative, but all of the possible ownership alternatives of the business. In other words, it is necessary to evaluate whether other multibusiness firms exist in which that business could achieve better results. This means identifying some alternative multibusiness firms that include or could include that business in their portfolio and trying to conduct the same evaluations cited above for the BOT. To justify the results reached by the BOT or BAT test it is thus important to perform a detailed analysis of how the corporate headquarters is able to add value to the businesses in the portfolio by influencing or supporting such businesses (vertical value), or by encouraging coordination between them (*horizontal value*).[26]

- *The capital markets test.* For reasons linked to the market, it may be that one or more businesses in the portfolio can have a higher (or lower) price than what would result from the application of the fair value method. In other words, if there is a mispricing, this point should be properly considered in the final evaluation.
- *The business logic test.* This test focuses on the analysis of the competitive advantage of each business in the portfolio. The dynamics of the industry in which a business operates may not allow for achieving satisfactory results because the return on capital employed in a specific business could be, or be in the process of becoming, lower than a certain weighted average cost of capital. In other words, even if the business passes both the BOT and the BAT test, it does not obtain a satisfactory profitability considering the risk level. For example, during the 2000s, the publishing industry in Italy saw a significant drop in profit of all of the competitors, due to the digital revolution, that made content that previously could be sold at good prices, available at very low prices (or even free). In such cases, the best choice is to sell the business or at least significantly reduce its weight within the firm independent of the added value logic.
- *The social and environmental sustainability test.* This test reflects the importance of corporate social responsibility in decision-making, and lets firms go beyond the pure shareholder value approach in decision-making to integrate the value created for all stakeholders. If this test is not passed, the firm can adopt specific strategic changes such as entering into some new activities or exiting from others. For example, to be sure to respect the criteria of social responsibility in the value

chain, a multibusiness food firm could favor a growth strategy based on vertical integration with suppliers. This matter and the impact on corporate strategy are very sensitive elements, as demonstrated by a recent article in The Economist, where six different types of owners and managers are identified in terms of the importance given to economic goals and social goals:

- *Corporate fundamentalists*: the increase of profits and share value in the shortest time possible is the only goal.
- *Corporate toilers*: the supremacy of economic value for the shareholders is confirmed, but within a more long-term orientation.
- *Corporate oracles*: for these types of owners and managers maximizing financial results is still important, but they are willing to sustain costs not required by law today, but that could arise in the future due to social changes underway.
- *Corporate kings*: the performance of the firm is so extraordinary that in this case owners and managers can allow themselves to invest in actions with social impact.
- *Corporate socialists*: they believe that some social objectives are more important than financial objectives.
- *Corporate apostates*: they are not at all interested in goals of a financial nature.[27]

1.7 Strategic management in multibusiness firms

How do multibusiness firms carry out strategic management processes? Although there are nuances depending on the specific corporate strategy approach adopted, three main thoughts can be formulated on this matter.

1. Regardless of the corporate strategy approach (synergy or financial), the corporate headquarters and the managers of the individual businesses are simultaneously involved in the strategic management process. Indeed, whether one prefers the top-down logic (from the corporate headquarters to the subsidiaries), or the bottom-up logic (from the subsidiaries to the corporate headquarters), both levels must play a role in the process. The choice of one logic or the other depends

above all on: (i) the culture of the corporate headquarters, that can be oriented towards greater or lesser autonomy of the subsidiaries; and (ii) the past performance reached by the management of the subsidiaries, better results generally favor the adoption of a bottom-up logic.

2. Strategic management processes differ in multibusiness firms that adopt a synergy approach compared to those that adopt a financial approach. In particular:
   - in the case of a large conglomerate recently committed to modifying its portfolio, the top management describes the process followed thusly: "at the corporate level, we conducted a review of our portfolio and we decided that we had to exit some businesses that in our view had reached an optimal value, and that we had to enter 'a few' new businesses with the following characteristics: large, with growth potential, international, and in a good financial position. We defined a three-year plan that in truth was rather basic, without many appendices. We then began the processes to search for buyers for the businesses we wanted to sell, and targets for acquisitions. In the end, one of the three main companies we acquired was the result of an unexpected opportunity. The top management of the businesses sold was broadly involved in the deal and interacted with potential buyers;"
   - in the case of conglomerates that are not acting to structurally modify their portfolio, the strategic management process essentially takes place using the chain of command of the governance model adopted. For instance, in the group led by the Benetton family, controlled by the holding company Edizione, the top management of each subsidiary prepares a multi-year strategic plan that is discussed and approved in the Boards of Directors where there are representatives of the holding company – as non-executive board members – who also actively participate in some committees (investment committee, internal control committee, or remuneration committee). The single plans approved by subsidiaries are then consolidated by the holding company, which monitors their execution on a yearly basis. Representatives of the holding company also participate in working groups organized by the subsidiary when it comes to potential and significant corporate

finance deals or important strategic projects. Those methods are followed by another conglomerate such as De Agostini group. The Managing Director Lorenzo Pellicioli describes the process as follows: "In addition to normal BoDs, we have a sort of executive committee for each of our subsidiaries, which in addition to me, includes Marco Drago (Chairman of De Agostini SpA), Paolo Ceretti (General Director of De Agostini SpA) and of course the management of the subsidiary. The committee meets ten times a year, and on those occasions precise information is given on the performance of operations. Between one committee meeting and the other, there may be a series of additional interactions with the holding company, or more specifically, with me or Ceretti. We are convinced that a conglomerate that invests in diversified sectors must work more on method than content. … We are shareholders, not 'masters,' and we act the way a good institutional shareholder would: we keep our place in the BoD, and we don't do micro-management, despite maintaining active relations with the management to improve the decision-making process;[28]

- in the case of multibusiness firms with a synergy approach, the strategic management process gives a much more important role to the corporate headquarters for two main reasons: on the one hand, the strategic plans of the single businesses must be defined taking into account the potential operational synergies achievable; on the other, on average a corporate headquarters has more industry-related competences that can support the decision-making at the business level.

3. In any case, the preservation of a flexible and iterative approach in planning is of a paramount importance because new ideas and elements can come up along the process. An interesting example is that of Zodiak (multimedia content), one of the subsidiaries of the De Agostini group. After having confirmed the intention to maintain control of that business in the 2014–2016 plan, in February 2016 the merger between Banijay (a competitor) and Zodiak was completed, that led the De Agostini group to reduce its stake in the new group to less than 50 percent. That choice was unplanned and driven by an opportunity: the Banijay group proposed a merger between the two firms to strengthen the competitiveness of the new combined entity,

and the corporate headquarters of the De Agostini group found that opportunity to be interesting.

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[1] In 2015, the Ferrari business was spun off from the FCA group to be listed independently.

[2] For a historical examination of the concept of corporate strategy, see Collis et al. (2012), ch. 2.

[3] www.strategicmanagement.net/ig-corporate-strategy/overview.

[4] Puranam and Vanneste (2016), p. 4

[5] For a detailed description of a methodology to identify the businesses, see Invernizzi (2014), pp. 42–45.

[6] Campbell et al. (2014), pp. 94–95.

[7] On the issue of defining corporate resources and business, value and not value, see Chapter 4.

[8] Collis et al. (2012), p. 8.

[9] On the concept of corporate scope, see Chapter 6.

[10] In some multibusiness firms, in particular in smaller and less complex ones, the organization adopts a functional form and organizational responsibilities are not defined for single businesses.

[11] For reasons of simplicity, only two levels are defined, and the level dedicated to coordinating the different units of a multibusiness firm is called the corporate headquarters. It is well-known that in very large and complex firms, intermediate organizational levels can exist, for example, that deal with a subset of businesses. These units can be considered similar to the business level or corporate level depending on the contents of their activities.

[12] From this point on, to avoid making the book more cumbersome, we will use the term “business” both to indicate one or more customer combinations (who), products (what), and value chain (how), and to indicate the organizational unit in charge of monitoring those combinations.

[13] Campbell et al. (2014), p. 27.

[14] Fair value is used to indicate the price at which an asset can be exchanged, or a liability extinguished, between knowledgeable and willing parties, in a transaction between independent third parties.

[15] See Chapter 13.

[16] Schein (1990), p. 111.

[17] To demonstrate the importance of ownership structure in strategy studies, suffice it to cite the area of research relating to family businesses, that in recent years has seen the involvement of an increasing number of scholars. Some of them concentrate precisely on the relationship between ownership and elements such as degree of diversification, M&A operations, the structure and functioning of the BoD, and the organization of the corporate headquarters.

[18] The classifications cited here are adapted from Collis et al. (2012), sect. 1.4.

[19] In 2014, this last business was sold to Galbusera, that already produced cookies and baked goods.

[20] Examples of resources relating to primary activities in the value chain are a sales network (tangible asset), a patent (intangible asset), a brand (intangible asset) or a brand development competence (organizational competence). An example of a resource relating to support activities in the value chain is the competence in financial management (organizational competency).

[21] Porter (1987).

[22] For a detailed description of the two logics we refer to Collis et al. (2012), ch. 13.

[23] With TRS, we intend the overall return for a shareholder. Its value is calculated by adding the increase of the share price, over a specific time interval, to the effect of the dividends per share paid in the same period.

[24] Campbell et al. (2014).

[25] Some authors believe it is sufficient to pass this test to evaluate the existence of a corporate advantage: "Corporate advantage exists if the collection of business owned together is somehow more valuable (i.e., generates higher total Net Present Value) than the sum of values of individual business owned in isolation from each other." Puranam and Vanneste (2016), p. 6.

[26] Campbell et al. (2014), chs. 7–8.

[27] *The Economist* (2017), p. 53.

[28] Bertoldi and Corsico (2015), pp. 116–17.

2 Portfolio Matrices

by *Giorgio Invernizzi*[1]

2.1 A tool for corporate strategy

Portfolio matrices are a strategic planning tool created to help leadership analyze the configuration of the portfolio, allocate resources, and prioritize the investments among businesses. Although this tool has been well-known since the 1970s, it shows multiple limits. It is not predictive and seldom identifies new opportunities since it deals mainly with existing businesses. It considers each business separately when they have to be placed within a matrix, although in multibusiness firms[2] value creation springs from their integration and coordination. It risks oversimplifying the competitive or organizational context in which businesses operate because the analysis is often restricted to only a few variables.

Despite these limits, if leadership is able to choose the right matrices and apply them properly, it can gain powerful insights to evaluate a corporate strategy and obtain some guidelines for making good decisions.

With regard to the approach to get the most from this tool, the main steps to take are the following:

1. Mapping businesses on matrices.
2. Evaluating the portfolio strategy.
3. Evaluating the parenting strategy.

2.2 Mapping businesses on matrices

From the perspective of the corporate strategy, we chose three matrices[3] to represent the three fundamental logics inspiring any kinds of decisions in this domain:

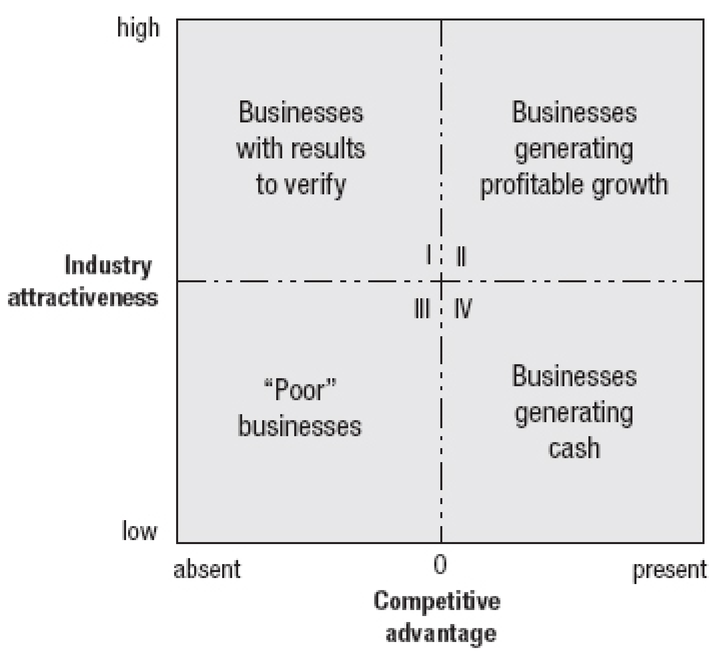
- The Business Attractiveness Matrix, for the business logic.
- The Heartland or Added Value Matrix, for the added value logic.
- The Fair Value Matrix, for the capital markets logic.[4]

2.2.1 Portfolio analysis according to the business logic

The Business Attractiveness Matrix shows the business logic of a portfolio through an analysis of two dimensions (Figure 2.1): [5]

1. The industry attractiveness (or market profitability) in which the business operates.
2. The intensity of competitive advantage (or disadvantage) achieved in that business.

Figure 2.1 The business attractiveness matrix



The vertical dimension of the matrix, or Y-axis, indicates the industry attractiveness, which can be estimated as the average profitability of the firm's direct competitors in the business considered, calculated as average Return on Capital Employed (ROCE).[6] If data on profitability is not available, leadership may use qualitative methods to judge the industry attractiveness, such as Porter's Five Forces of Competition Framework that views the profitability of an industry as determined by five sources of competitive pressure.[7]

The line of demarcation between "high" and "low" attractiveness can be defined as the average profitability of all of the industry over the time frame considered.[8] In case of qualitative measures, the positioning of the line of demarcation is more subjective.

The horizontal dimension of the matrix, or X-axis, records the intensity of the competitive advantage of a business that can be measured in two alternative ways as:

1. The gap between the ROCE generated by the business and the average in the industry to which it belongs. The line of demarcation separating the area characterized by an advantage from that of disadvantage, is thus equal to "zero" (that is, any businesses that generate a ROCE exactly equal to the average ROCE of direct competitors).[9]
2. The gap between the ROCE and the Weighted Average Cost of Capital (WACC) for the single business. As a consequence, a competitive advantage occurs only when the ROCE is higher than the WACC.

In the event of a qualitative assessment of the competitive advantage, a ground principle can be taken into account: only businesses commanding market power or having resource superiority have a competitive advantage. In particular, the resource-based view states that a competitive advantage depends on the exploitation of the uniqueness of the firm's portfolio of resources, through a distinctive strategy and a well-designed organization. This uniqueness results from the development and deployment of "valuable business resources," as will be described in Chapter 4. The more the firm is able to control valuable business resources, the stronger the competitive advantage in a business is.[10]

The matrix is divided into four quadrants, which identify different categories of businesses whose results should be carefully investigated. Businesses located in quadrants II and IV require an understanding of the sources of the competitive advantage to check if they can be isolated and protected from innovation and imitation. Businesses in quadrant III are the most critical because they compete in unattractive industries and suffer a competitive disadvantage. Businesses in quadrant I require an in-depth review to check if a competitive advantage can be realistically built in the medium-term.

2.2.2 Portfolio analysis according to the capital markets logic

The Fair Value Matrix shows the capital markets logic of a portfolio through an analysis of two dimensions: the market price (on the Y-axis) and the *fair value* (on the X-axis).

The Y-axis measures the price that a buyer is willing to pay to acquire a business. In the simplest case, the price is set by an offer received (i.e., bid price). If an offer is not available, the price is equal to the stock price of the business for listed companies.

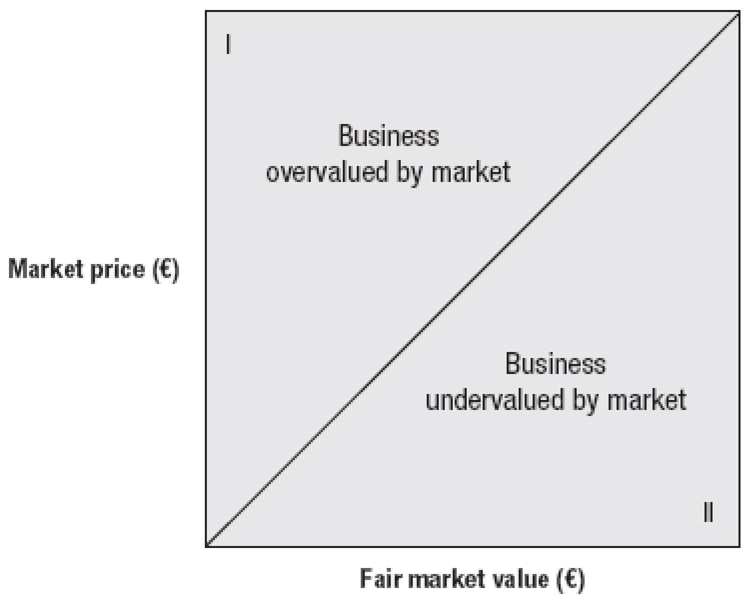
The X-axis measures the fair value of the business which can be calculated through the unlevered discounted cash flow method or the Comparable Company Analysis.[11]

The Fair Value Matrix aims at investigating if the market price of each business is aligned with its fair value or not. In the first case, the business will be placed along the diagonal of Figure 2.2; in the second case, there are two options:

- If the market price is higher than the fair value, the business will be located in the triangle I where we find units belonging to industries that are overvalued by the market (think of the segments linked to Internet at the end of the last century, or the overvaluation of the luxury segment in the first decade of this century). Such overvaluation usually depends on market inefficiency or an imbalance between supply and demand on the market. An example of this positioning is the Seat Pagine Gialle business in the De Agostini portfolio at the beginning of the 2000s, as documented in Box 2.1.

- If the market price is lower than the fair value, the business will be located in triangle II where we find businesses undervalued by the market for the following main reasons: (i) the scarcity of buyers that can be due to the limited development of the capital markets, the excessive size of the business, or the risk of legislative actions placing restrictions on business; (ii) the characteristics of the buyers in terms of motivations for a potential purchase, competences and abilities in the negotiating process, and more or less optimistic attitudes relating to the future; (iii) information asymmetry in the market.

Figure 2.2 The fair value matrix



Box 2.1 The De Agostini – Seat Pagine Gialle case

In February 2000, what was called "the first Italian marriage of the Internet Era" was announced. Telecom Italia (then led by Roberto Colaninno) and Seat Pagine Gialle decided to join the activities of Tin.it – the leading Italian network operator – and Seat, owner of the Virgilio search engine (the "Italian Google") that was active in advertising and electronic commerce. At the end of the transaction, Telecom achieved the control of the new entity, while De Agostini completely divested its stake in Seat, for a value of over 2 billion euros. A couple years later, Marco Drago – majority shareholder and President of the De Agostini group – recalled those events this way: "Seat was an investment that was wise to divest, faced with an offer that de facto advanced the dividends for the next 100 years" (*Corriere della Sera*, May 22, 2004).

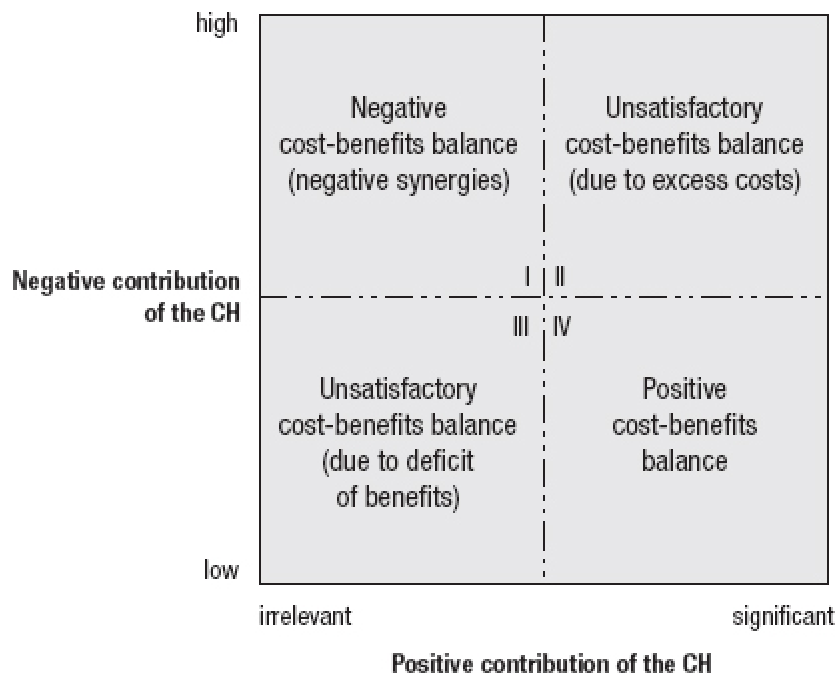
2.2.3 Portfolio analysis according to the added value logic

The Heartland or Added Value Matrix represents the added value logic of a business portfolio. Added value results from the combination of two contributions:

- The positive contribution of the corporate headquarters (CH) to the competitive strategy of each single business, which depends on two factors: (i) the relationship between the single businesses and the corporate headquarters (or value generated vertically through so-called "vertical synergies"); and (ii) the relationship – coordinated and mediated by the corporate headquarters – between the different businesses belonging to the same firm (or the value generated horizontally through "horizontal synergies"[12]).
- The negative contribution of the corporate headquarters to the competitive strategy of each single business, which derives from specific circumstances such as unproductive overhead costs borne by businesses or the negative influences exercised by the corporate headquarters due to a mismatch between the critical success factors of the business and the characteristics of the corporate headquarters.

The Heartland or Added Value Matrix is illustrated in Figure 2.3.

Figure 2.3 The fair value matrix



To position the business on the horizontal axis of Figure 2.3, a simple method to adopt consists of identifying the vertical and horizontal synergies impacting the performance of a business. As an alternative, it is possible to assess the fit between the *characteristics of the corporate headquarters* and the *opportunities to create synergy*. The stronger the fit is, the stronger the positive contribution of the corporate headquarters is.

The so-called *characteristics of the corporate headquarters* are traceable to four elements:

- The mental or cognitive maps guiding leadership working in the corporate headquarters, including values orienting decision-making.
- The organization of the corporate headquarters (structure, management systems and processes) such as number of organizational units, kind of centralized functions, type of planning system, and type of performance management system.
- The extent to which the corporate headquarters has decentralized by delegating authority and responsibilities to the leadership of the

businesses.

- The resources available at the corporate level. Specifically, the organizational competences of the corporate headquarters, which mainly depend on the skills of the leadership and people working in this part of the organizational structure.

The *opportunities to create synergy* are the potential for improvement within a business thanks to the contribution of corporate headquarters. For example, a corporate headquarters can share of technology or a corporate brand between different businesses as well as transferring a marketing competence to a specific business. Opportunities to create synergies are also known as parenting opportunities: the vertical and horizontal synergies mentioned above. The concept of "parenting" derives from the idea that a multibusiness firm brings together under a parent company – the corporate headquarters – a portfolio of businesses that could potentially be independent on an organizational level (as divisions) or from a legal perspective (as subsidiaries). Corporate headquarters can thus influence or parent the businesses through the deployment of a proper parenting strategy as described in Chapter 1.

To position the different businesses on the vertical axis, the possible alternatives are:

- Judging all value destroyers related to the functioning of the corporate headquarters. Value destroyers are: overheads costs, negative influences, resource limitations, and cost of complexity.[13]
- Calculating the size and cost of the corporate headquarters and comparing such measures with those of comparable multibusiness firms. If the corporate headquarters is disproportionate compared to that of direct competitors, the competitiveness of the business may suffer substantially.
- Investigating the fit between the "critical success factors" of a business and the characteristics of the corporate headquarters and/or those of the core business.[14] The critical success factors are the activities or issues critical to succeed and create a competitive advantage in a business. If the fit is high, the business will be mapped in the "bottom" part of the matrix shown in Figure 2.3 (quadrant III or IV); otherwise, it will be above the line of demarcation.[15]

- Exploiting the transaction costs approach. The higher the governance costs related to a business are, the more the negative contribution of the corporate headquarters is. Governance costs are the costs sustained by the corporate headquarters to obtain collaboration from businesses.[16] They depend on the need to avoid resistance to cooperation and coordination and on the number of actions to be taken to verify that cooperation and coordination actually takes place as expected.[17]

Finally, to position the different businesses in the matrix, the BOT test (*better-off test*) and the BAT (*best-alternative test*) can also be used. In the first – the horizontal dimension of the matrix – the business must create greater value (it must be "better off") within the firm's portfolio with respect to its stand-alone ownership and management; while the second – the vertical dimension of the matrix – aims to create a comparison between the value created by the business in the multibusiness firm and the value generated in all of its possible configurations within other firm portfolios.[18]

It is worth noting that the mapping of businesses in this matrix, as in the previous ones, is not (and must not be) the result of an automatic application of data or scores. Rather, it is the result of a process of evaluation and appraisal based on an in-depth knowledge of the corporate strategy and external context in which it is pursued.

2.3 Evaluating the portfolio strategy

Evaluating the portfolio strategy means seeking a response to the following types of questions:

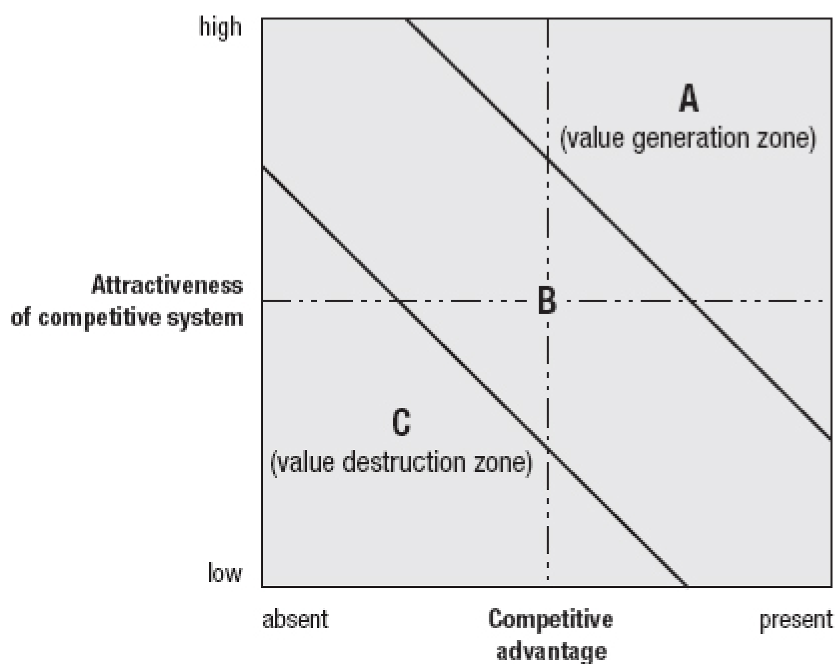
- Is the strategic positioning of the single business better or worse than others in the business portfolio? In what areas is it better (or worse)?
- Can the firm's current strategic positioning in the different businesses be considered stronger or weaker than rivals?
- Is the business portfolio balanced from a financial standpoint?
- Is the business portfolio exposed to disruptive dynamics? Which businesses allow for mitigating the impact of structural crises?

- Is the business portfolio balanced to mitigate or reduce risks such as industry risk, country risk and currency risk?
- Does the market evaluate the single business better or worse than the firm itself evaluates it? Is the fact of belonging to a multibusiness firm negative or positive for the specific business in the market's view?
- Does the firm or specific businesses suffer from a corporate discount? 19

To explore such questions and evaluate a portfolio strategy it is useful to refer to the matrices, that allow to delve into the business logic and the capital markets logic.

The Business Attractiveness Matrix identifies three zones with different types of challenges and issues (Figure 2.4).

Figure 2.4 The evaluation of portfolio strategy according to the business logic



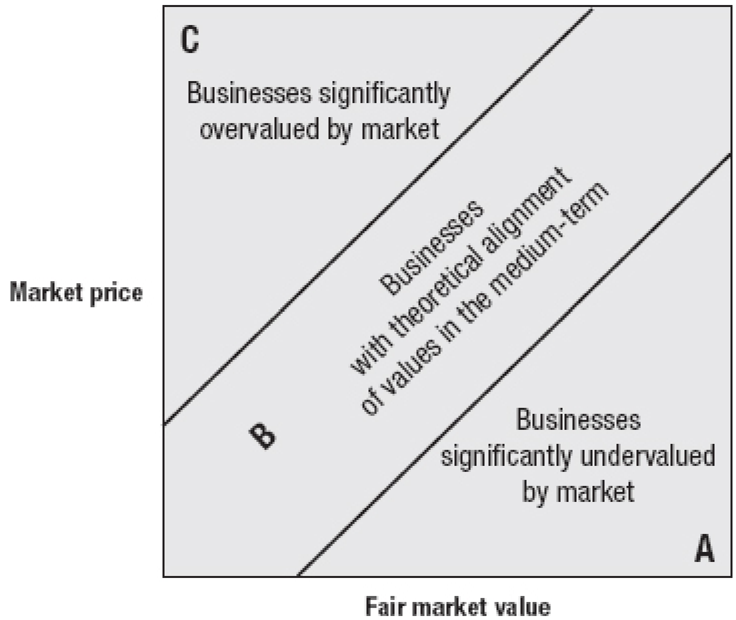
The effectiveness of the portfolio strategy will be better when most of the businesses are mapped in zone A. This is the "value creation zone," since there are sound opportunities to "extract value" (horizontal axis) in industry with a high potential of "value generation" (vertical axis). Those businesses are to be protected, and the leadership must focus its resources and energies on them in order to further improve their competitive advantages or to make them increasingly sustainable.

If the placement of businesses within the matrix shows a concentration in zone B, it is possible to provide a definitive judgment on portfolio strategy effectiveness only through an in-depth assessment of industry attractiveness and/or competitive advantage. Businesses placed in the upper part of zone B tend to have high levels of profitability, but also high risks linked to the industry dynamics. Businesses placed in the lower part of zone B still suffer from industry dynamics, although they have a competitive advantage that drives success. Zone B is traditionally a zone for selective investment to help a business thrive or to move to zone A.

If most of the businesses have been placed in zone C (value destruction zone), the effectiveness of portfolio strategy is very poor. These businesses should be sold, liquidated or run just for cash.

The evaluation based on the business logic then has to be supplemented with the one based on capital markets logic. Figure 2.5 shows how the placement of businesses within the Fair Value Matrix can be traced back to three zones.

Figure 2.5 **The evaluation of portfolio strategy according to the capital markets logic**



For businesses placed within zone B, the judgment based on the business logic can be confirmed. For businesses placed within zone C, the judgment on the business logic has to be upgraded. The leadership should also consider a divestment to exploit the mispricing between market value and fair value, even if they are placed in zone A of the Business Attractiveness Matrix.

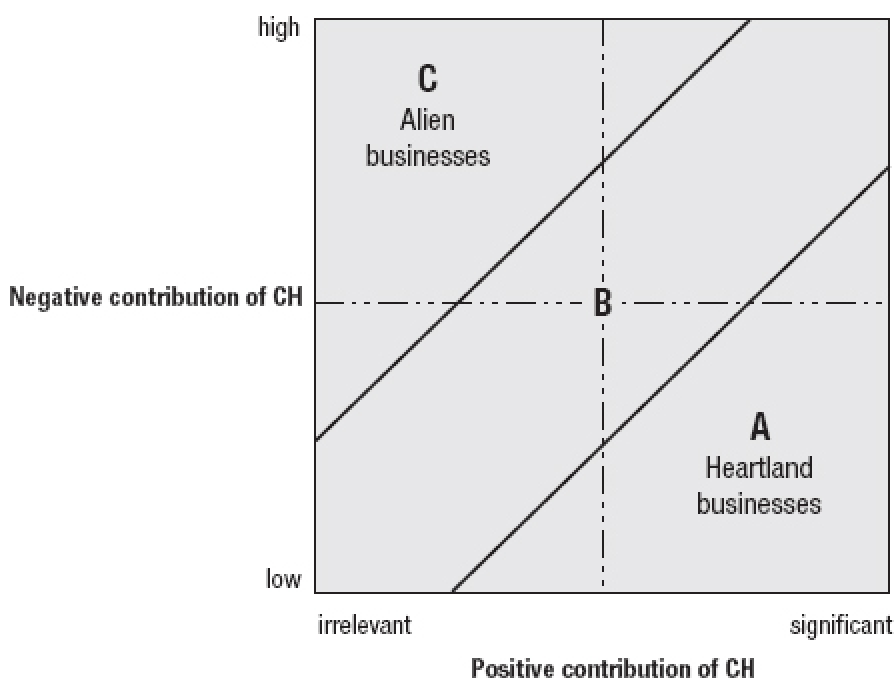
For businesses placed within zone A, the judgment based on the business logic has to be downgraded. The leadership must start asking themselves why capital markets have a different valuation than the one calculated internally. The hidden value of a firm should be "extracted" on managerial view by improving financial communication, changing the parenting strategy, or promoting a divestiture of businesses that do not benefit from being part of a multibusiness organization.

To complete the evaluation of a portfolio strategy it is necessary to look on the added value logic and the governance and compliance logic.[20] The first logic will be examined in the next section, using the Added Value Matrix (Figure 2.3) while the second logic introduces matters that cannot be placed within a matrix and need to be further investigated separately by reflecting whether the firm is compliant to external rules, regulations and the internal control and risk management system.[21]

2.4 Evaluating the parenting strategy

The Added Value Matrix sorts the businesses into three categories or zones, and allows for directly evaluating the parenting strategy of a multibusiness firm and indirectly contributes to the evaluation of the portfolio strategy (Figure 2.6).

Figure 2.6 The evaluation of the parenting strategy



Businesses placed in zone C are called alien-territory business because they do not gain a net benefit for being part of the multibusiness firm. The corporate headquarters' influence on businesses is almost neutral or negative and the business might perform better whether it would as a stand-alone firm. If an alien-territory business cannot be moved into zones

B and A through changes in parenting strategy, they are candidates to be sold because the relationship between them and the corporate headquarters is destroying value.

Businesses placed in zone B can be in two situations. Either they do not benefit substantially from being part of the multibusiness firm but they fit with the characteristics of the corporate headquarters, or they might benefit from being part of the multibusiness firm but the potential value creation cannot be extracted due to the misfit between the corporate headquarters and the business. In zone B, the parenting strategy needs to be revised through selective investment or organizational actions to move these businesses into zone A. If this is not possible, sooner or later they should be sold.

Businesses placed in zone A fully exploit all benefits of being part of a multibusiness organization and should have priority in resource allocation.

If we find a concentration of businesses in zone A of the Added Value Matrix, the judgment on the portfolio strategy based on the business logic should be upgraded; otherwise not. If capital markets do not understand the added value logic and they believe that the synergies are just theoretical, rather than substantial, leadership should commit itself to better communicating the strategy and giving evidence of the value creation that the multibusiness can exploit through a diversification not achievable by a single shareholder alone.

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[2] The reflections contained in this chapter are also applicable to business groups. For reasons of simplicity, we use the term "multibusiness firms" here. For a further discussion of the issue of business groups, see Chapter 14.

[3] Campbell et al. (2014)

[4] For more on those logics, see Chapter 1.

[5] Among the different versions present in the literature and in consulting practices, Figure 2.1 comes closer to matrices focused on the "competitive profile/industry profile," and among these to the McKinsey-General Electric matrix, while it differs from the classic BCG matrix due to the

use of the concept of “industry attractiveness” (rather than “market growth rate”) and of “competitive advantage” (rather than “relative market share”). For a detailed description of the different versions of portfolio matrices, see Invernizzi (2012).

[6] To be more precise, the Y-axis in Figure 2.1 should take into account not only average profitability, but also its variance in the medium-term, given that, at equal average profitability, greater variance makes an industry less attractive.

[7] Porter (1980).

[8] Coda, Invernizzi and Russo (2017).

[9] Campbell et al. (2014), Invernizzi (2014).

[10] Grant (2017), Coda, Invernizzi and Russo (2017).

[11] A Comparable Company Analysis (CCA) is a process used to evaluate the value of a firm using the metrics of other businesses of similar size in the same industry. CCA operates under the assumption that similar companies will have similar valuation multiples, such as EV/EBITDA.

[12] For further discussion of the concepts of horizontal and vertical synergies, see Chapters 4 and 14.

[13] See Chapter 14.

[14] For the concept of core business, see Chapter 5.

[15] In practice, the less familiar the business is with respect to the characteristics of the corporate headquarters, the more costs will be sustained to manage it.

[16] Both transaction costs and ownership costs are defined as “governance costs” by Puranam and Vanneste (2016), p. 71, who drew on the classic studies by Coase (1937) and Williamson (1975).

[17] In particular, the costs for cooperation consist of the costs related to initiatives aimed at ensuring that the managers of two (or more) businesses are motivated to work together. These costs also regard those of managing the relationships between various organizational units of the firm such as the costs of information systems.

[18] See Chapter 1.

[19] For the concept of corporate discount, see Chapter 8.

[20] To further examine that logic and compare it with the other logics cited previously, see Chapter 1.

[21] The Corporate Governance Code of listed firms defines the internal control and risk management system as the set of rules, procedures, and organizational structures for an effective and efficient identification, measurement, management and monitoring of the main risks, aimed at contributing to the sustainable success of the company (art. 6).

3 The Integration of Corporate Social Responsibility

by *Luana Carcano*[1]

3.1 From shareholder value to shared value

The world of business is increasing accepting responsibilities that extend beyond the interests of owners by moving towards the principle of maximizing shared value, understood as the value generated by the firm for all stakeholders.[2]

The fact that there is more to business than making a profit has been a central argument in the debate over corporate social responsibility (CSR), which was introduced for the first time in 1953 in Bowen's book *Social Responsibilities of the Businessman,* and is now an integral part of a good corporate strategy.

Many studies have demonstrated that a greater orientation towards sustainability can favor value creation in the long-term and a greater return for shareholders, thus strengthening corporate advantage and making it sustainable. For example, the Harvard research group led by Eccles analyzed the differences in results between firms with high or low attention to sustainability over a period of twenty years, and found better performance in the former, in terms of both shared value and profitability.[3] In addition, the most sustainable firms recorded lower volatility of performance over the same period of time.

Today, many firms have wisely been deciding to modify their strategies to position themselves as sustainable. Some of them set themselves ambitious goals as we will describe in the next sections.

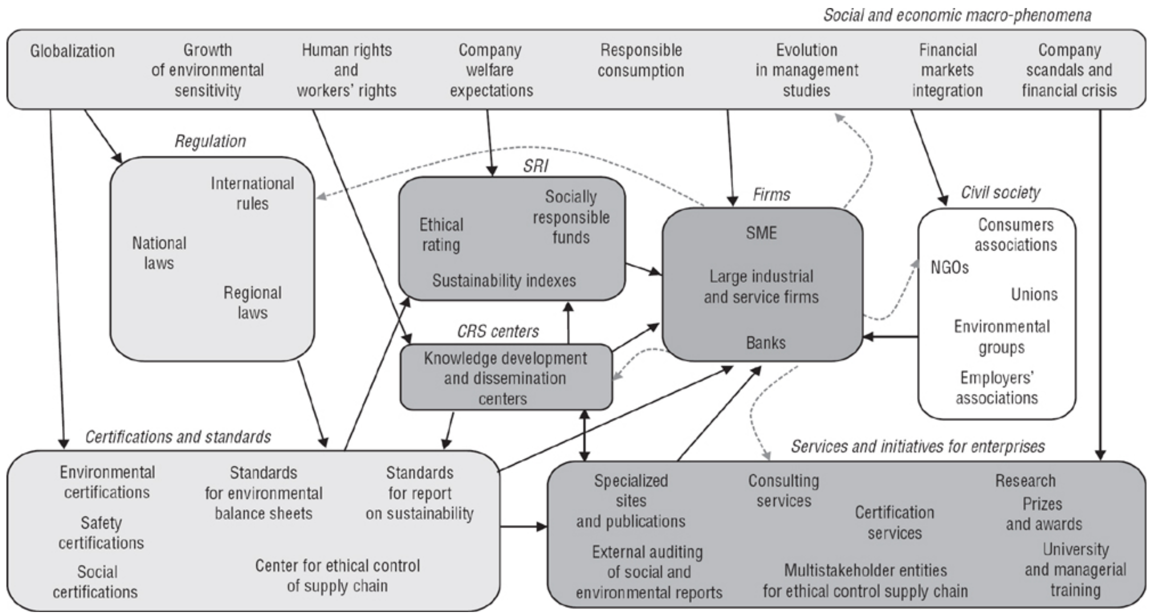
Looking ahead, the central issue remains how to accelerate the path towards sustainability in the global corporate world. Several factors and practices can facilitate the transition, such as a review of the firm's purpose; a better prioritization of projects and activities to create competitive advantage and social outcomes; the recognition of a bolder role for governments and intergovernmental bodies (such as the United Nations Conference on Trade and Development) on this subject; and a stronger partnership between the business and the world of the poor – i.e., the bottom of the pyramid – to meet the firm's responsibilities to society while sustaining growth, innovation and prosperity.[4]

Finally, although significant progress has been made in theory and in practice, we cannot overlook the fact that the case for CSR still needs to be managed carefully, to combine ethics with efficacy.

3.2 The influence of the external context on CSR

Attention to sustainability is linked to the attempt to respond, or better, to anticipate, changes in the social, environmental, and economic context. Such changes represent the "CSR drivers," the reasons why firms are stimulated to follow corporate social responsibility practices (Figure 3.1).

Figure 3.1 The external context – the CSR driver



Source: developed by authors based on M. Molteni, *Responsabilità sociale e performance d'impresa. Per una sintesi socio-competitiva*, Milan, Vita e Pensiero, 2004.

Among the CSR drivers, the ones related to the external context have played a key role in supporting the adoption of the CSR on a large scale. First of all, starting in the mid-1990s, important economic and social transformations strengthened the sensitivity of firms on issues of sustainability, such as the process of globalization led by increasingly large multinational firms, climate change, and the greenhouse effect, that put environmental protection at the center of public debate and encouraged the search for renewable energy sources.

Another important CSR driver was the growing attention to human and workers' rights regarding health and working conditions, that pushed firms to evolve their personnel policies and promote welfare projects.

Then, the spread of responsible or sustainable consumption of good and services contributed to accelerating the change. These practices resulted in new criteria for product selection by end users, the emergence of trends such as fair trade, and the adoption of production patterns by manufacturers to use resources efficiently and reduce the negative impact on climate and the environment, and on people's health.

The request for greater transparency and ethical behavior amplified by corporate scandals and bankruptcies also played a key role in this evolution as well as the enactment of laws, the adoption of regulations and the issue of recommendations by various institutions such as the United Nations, the European Union, the Organization for Economic Cooperation and Development, and Governments. In this perspective, it is worth noting the adoption of the "2030 Agenda for Sustainable Development" at the UN Sustainable Development Summit in September 2015, which includes 17 Sustainable Development Goals (SDGs) at its core. SDGs are a call for action by all countries – developed and developing – for peace and prosperity for people and the planet.[5]

Therefore, many standards, certifications and legal frameworks regarding the environment, workplace safety, labor standards, human rights, and social practices have been introduced over time to help firms operate and work in accordance with CSR principles and to make them more and more conscious of the responsibility they bear in their sphere of influence.

Lastly, a strong impulse on this subject also came from key opinion leaders, not-for-profit organizations, environmental groups, consumers associations, and various entities that offer firms a range of services concerning social responsibility.

3.3 The different responsibilities of firms[6]

A well-known model for defining the firm's responsibilities is the Carrol pyramid. Published for the first time in 1979 and revisited in 2016, the pyramid sets the variety of firm's responsibilities and divides them into four main categories:

- *Economic responsibility* represents the firm's reason for existence, especially within today's hyper-competitive world. Only if the firm is profitable in the long-term can it guarantee its continuity and the satisfaction of the various stakeholders involved.

- *Legal responsibility* regards the compliance with laws and regulations which each country adopts. By fulfilling this responsibility, firms respect the "codified ethics" that include the basic notions of justice and fair operations established by lawmakers.
- *Ethical responsibility* concerns the method of conducting business. It refers to respect for those behaviors, practices, and activities expected by society, even if they are not codified into law. Society includes clients, employees, shareholders, and the community. These responsibilities often embrace new emerging values and norms society expects firms to meet, leading to higher CSR standards than those required by the law.
- *Philanthropic responsibility* defines the contribution firms make to society or their communities. It includes all of those activities that are not mandatory by law or expected from an ethical standpoint. These initiatives give substance to the concept of *corporate citizenship* and strengthen the firm's reputation. In order to fulfill this responsibility, firms are involved in a large variety of activities, such as donations, support for social projects, voluntary activities by management and employees, and participation in the development of the community. Philanthropic initiatives are the most discretionary within CSR activities, although there is always a societal need that the firm satisfies.

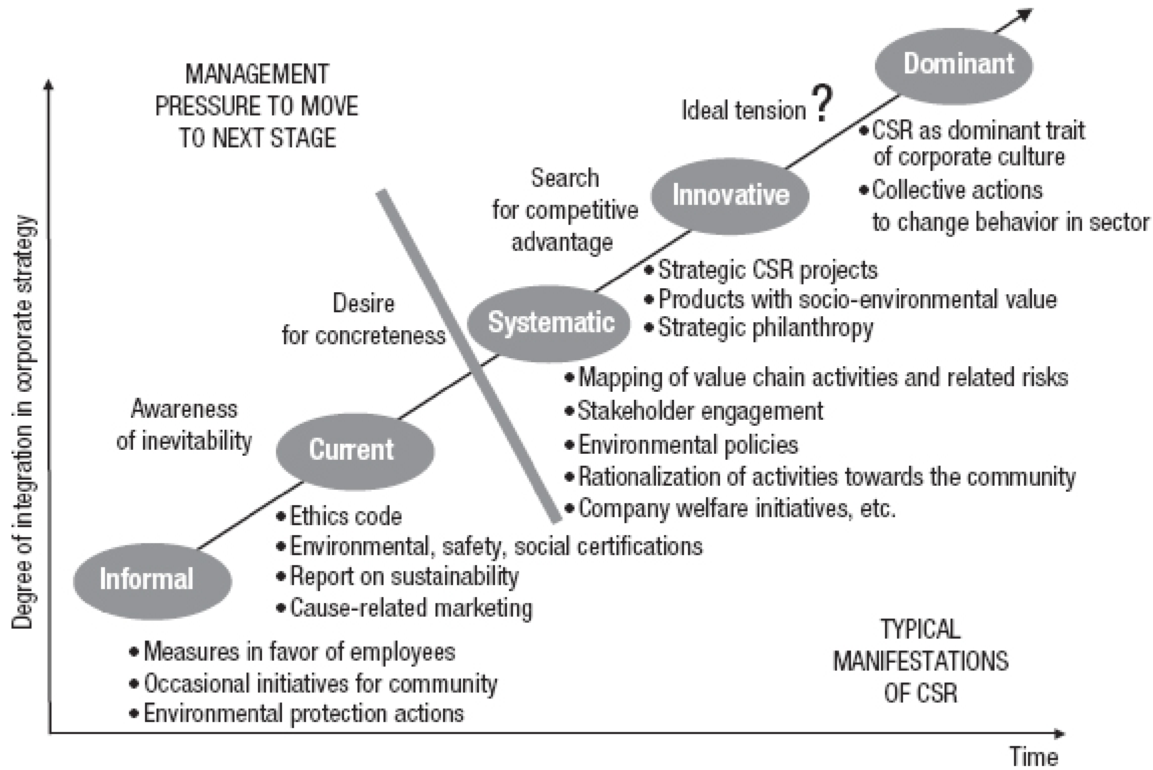
The geographical depiction of responsibilities as a pyramid aims to transmit the idea that, through their actions and decisions, firms are called on to simultaneously satisfy all four categories. Notably, the pyramid's base consists of the economic responsibility, because it is a foundational requirement of business. On this foundation a second layer is built, which is occupied by the legal responsibility: besides pursuing a profit, businesses are also required to comply with the law. Moving up, at the third layer of this architecture symbolizing Carrol's thinking is placed the ethical responsibility, or how a business behaves in an ethical fashion. Unlike previous categories, this is expected by society, not required. Finally, at the top of the structure rests the philanthropic responsibility, which shows the engagement of the firm to demonstrate its good citizenship. Such a responsibility is desired by society.

The specific social and environmental orientation of a firm depends on how it balances the four different responsibilities and how it handles the trade-offs in decision-making.

3.4 Corporate strategy and CSR: the stages of integration

In multibusiness firms, how CSR is integrated in the corporate strategy mainly depends on the level of commitment and motivation of ownership, corporate governance and leadership as well as how the interaction among the three actors takes place. Because there are different nuances in being socially responsible, we classify each firm in one of five stages along the journey of integrating CSR activities into corporate strategy, as shown in Figure 3.2. The classification is based on the observation of behaviors and outcomes delivered by the firm, not merely on intentions.

Figure 3.2 **Stages of evolution of CSR in corporate strategy**



Source: D.J. Collis, C.A. Montgomery, G. Invernizzi, M. Molteni, *Corporate Level Strategy*, Milan, McGraw-Hill, 2012.

3.4.1 Stage 1: Informal CSR

In this stage, the commitment to socio-environmental issues is not formalized, although firms may have developed measures in favor of employees and to protect the environment or promoted donations or initiatives towards the community

The CSR agenda is usually defined by specific individuals within the firm who are motivated by personal preferences or by the need to respond defensively to external pressure. For example, consider the reaction of the main players active in diamond mining at the beginning of the new millennium, to the great media attention created by the film *Blood Diamond*, which brought to light business practices in the jewelry industry that were not always ethical. The large multinationals in the industry rapidly agreed on the creation of a certification (the Kimberly Certificate) that allowed customers to trace the path of the stone contained in the jewel, from its extraction in the mine to the point of sale.

Informal CSR can also be reflected in promotional initiatives and communications campaigns aimed principally at strengthening a firm's reputation, without evident or substantial benefits for society as a whole.

3.4.2 Stage 2: Basic CSR

The shift to this phase results from the recognition of the inseparability of social and environmental issues from the firm's economic responsibilities. This implies that leadership is actively involved to comply with relevant rules, laws, policies, and regulations.

In this stage, the firm usually equips itself with:

- *Ethics code* – this is a document containing the values on which the firm's culture is based; the responsibility statement towards clients, associates, shareholders, the local and national community; and policies on the subject of ethics.
- *Social report* (or *sustainability report*) – this is an annual document, drawn up together with the financial statements, through which the firm communicates its CSR initiatives and their results, usually divided into three categories: economics, environment, and social (known as the triple bottom line).
- *Certifications* – these can regard the environment, safety, or the social impact of the firm's activities, including along the supply chain.

A firm may also launch some *cause-related marketing initiatives*, which are communication and sales initiatives developed to achieve both economic results and social goals by allocating a percentage of sales to charity or to support a social initiative.[7]

In the *basic* phase, CSR is not yet broadly integrated with the corporate strategy. The initiatives are perceived more as formal requirements, while the various stakeholders are often involved in these activities with the main goal of preventing possible opposition. Sometimes firms at this stage still exploit the CSR to minimize any damage to reputation with the effect to translate this kind of initiatives into purely symbolic actions, called *greenwashing*.

3.4.3 Stage 3: Systematic CSR

In this stage, the firm develops the awareness that the ability to satisfy social and environmental expectations can represent a resource able to support the competitiveness of the businesses forming the portfolio. As a consequence, the corporate headquarters starts becoming engaged in making CSR an integral part of corporate strategy and in defining systems and policies that encourage single businesses to consider issues and opportunities of a social and environmental nature and to tackle them. This approach leads to the definition of CSR targets during the strategic planning process, with the same level of importance as financial and competitive goals.

From an operational standpoint, some specific techniques are used in this phase such as stakeholder management, risk mapping and value chain analysis, to identify the impact of CSR and make commitments for the future. Other CSR activities at this phase are the transfer of CSR best practices among businesses; volunteer programs for employees; diversity management initiatives; introduction of CSR targets in performance management; and the formalization of policies, such as for responsible management of the supply chain.

Usually, the corporate headquarters proposes a shared model for implementing the numerous activities within the firm and is committed to finding the common thread between all activities to shape the firm's socio-environmental identity.

3.4.4 Stage 4: Innovative CSR

In this phase, the firm proactively promotes strategic projects that can create value for both the firm and for society. CSR becomes an integral part of the strategy because it navigates "the intersection between the interests of the firm and those of the society"[8] to create a competitive advantage while generating a social outcome.

These projects address issues and problems of one or more stakeholders beyond what is normally expected or required by law, and sustain the firm's performance including the competitiveness of businesses. They are characterized to generate innovative products and processes with a social impact, which may even become strategic differentiators to compete.

3.4.5 Stage 5: Dominant CSR

In this stage, we find players in which CSR is a key part of the firm's purpose, if not the purpose. CSR is thus a central tenet in the vision and mission statement, and not limited to promoting some strategic projects as described in the previous stage. In addition, CSR becomes a corporate value while the leadership has usually the charisma and sense of stewardship necessary to instill CSR in day-by-day management. This stage corresponds to the CSR 2.0 of Visser.[9]

Firms able to reach the dominant CSR stage adopt the "integrated thinking" approach in decision-making, defined by King and Roberts[10] as the recognition that strategic decisions are the result of an integrated analysis of the impacts, benefits, and risks not only for the firm but also for society and the environment. Performance management and reporting systems in these firms follow the principle of "being integrated" as well: targets include economic, environmental, social, and governance dimensions while reporting complies with the guidelines of the International Integrated Reporting Council (IIRC).

Many firms with dominant CSR become a point of reference or an example to be imitated for others. In this stage, we include all companies that have been able to obtain the B-Corp certification.

3.4.6 B-Corps: Dominant CSR

B (or *Benefit*) *corporations* (or B-Corps) are certified firms that combine attention towards socially responsible activities and economic performance. They “compete not to be the best in the world, but the best for the world.”[11]

B-Corp status is certified by a non-profit organization, B-Lab, that in 2019 represented a growing community of more than 2,700 firms from 64 countries and 150 industries. The certification is issued after a careful analysis of the firm’s business model and an evaluation of CSR performance in four areas:

- *Environment* (the presence of recyclable products, for example).
- *Community* (attention to minorities, for example).
- *Workers* (such as the presence of benefits and training and development activities).
- *Customers* (through the characteristics of the product or service offered).

To obtain the certification, firms must first complete an impact assessment that measures the impact of day-to-day operations and the business model: what the firms do and how the firms do it. A minimum score has to be obtained to be eligible for this certification. Then, firms are legally required to integrate their commitment towards CSR into their articles of incorporations or by-laws.

There are three provisions in particular that a B-Corp must follow:

- Pursue a tangible social impact of general interest with which to align all strategic actions.
- Commit to expanding its duties towards all the stakeholders and not only towards shareholders.
- Transparently communicate economic and social results. In general, the annual report must be certified by third parties to ensure credibility and transparency.

Although any firm – independent of its size, legal structure, or industry – can become a B-Corp, currently, the majority of firms that have taken this path are small and medium-sized private firms. Most of them pursue a competitive strategy based on differentiation, with a strong emphasis on social and environmental impact.

An example of a B-Corp is represented by Davines,[12] an Italian group active in the production of cosmetics and hair care products distributed worldwide. The group obtained the B-Corp certification in 2015. The firm's vision revolves around the concept of "sustainable beauty." The attention to sustainability is present in all its activities and processes. Product development, for example, must respect guidelines defined in terms of ingredients – natural, organic, or eco-certified – and formulas that allow for production with eco-friendly processes. This effort is communicated to customers through the Science-Based Conscious Formulas certification that identifies products without silicone, parabens, mineral oils, artificial colors, animal-based ingredients, sulphates, and with a preference for products without alcohol. The group procures raw materials from suppliers who work with agricultural firms to make the products as natural as possible. In production, great attention is paid to renewable energy, the reduction of waste from emissions, and the use of eco-friendly packaging. The firm has also adopted an Ethics Charter drafted by its employees in collaboration with a philosopher who contributed to identify the firm's key values to defend and protect. Lastly, the firm's image is promoted through communication plans that promote the concept of beauty in artistic, social, and environmental fields.[13]

3.5 Organizational choices regarding CSR

Multibusiness firms reaching the systematic CSR stage usually face the issue of how to define organizational responsibilities to deliver CSR activities effectively. On this matter, a study by the Corporate Responsibility Officer Association (CROA) shows some interesting results:[14]

- 62 percent of firms in the sample have formalized a position relating to corporate social responsibility.
- 40 percent have introduced the role of Corporate Responsibility Officer (CRO).
- 51 percent of CEOs and 23 percent of board members have stated that they actively guide CSR projects and initiatives.

Ideally, multibusiness firms should have a position dedicated to CSR at the corporate level with the responsibility to coordinate and integrate the firm's various initiatives.[15] Those who hold this position are accountable for:

- Guiding the CSR initiatives and programs within the firm.
- Supporting and disseminating the commitment to CSR both internally and with external stakeholders.
- Defining goals and systems for evaluating results.
- Engaging the most important stakeholders, from policymakers to NGOs, in creating collaborative relationships/alliances.

By and large, the organizations dedicated to CSR are designed according to the approach to corporate strategy. A centralized unit within the corporate headquarters is usually created by firms adopting a synergy approach. In these cases, the CRO defines the CSR strategy and budget, allocates resources, and controls and coordinates all initiatives promoted at the corporate and business level.

In firms adopting a financial approach, on the other hand, the organization usually consists of a lean unit at corporate headquarters and a network of decentralized units staffed at the business level. In this case, the role of the CRO is more to support and influence organizational behavior and to establish macro guidelines and share best practices. Therefore, the CSR strategy and budget are normally set at the business level.

In the most structured organizations, the CSR team also includes the following roles:

- The CSR communications director, who communicates the CSR strategy internally and externally and produces the annual CSR report.
- The director of CSR procurement, who defines and implements the sustainability strategy with suppliers and throughout the supply chain.
- The environmental and sustainability director, who is responsible for impact on the environment and on firm safety and the surrounding community.
- The director of the foundation or the person responsible for philanthropy projects.

Finally, as for the process of planning new CSR projects, it can take place following a bottom-up approach or a top-down approach. Ikea, for example, developed a top-down approach with the 2011 appointment of a Corporate Social Officer (CSO) as a part of the executive management group, that defines corporate vision and strategy. His work facilitated the development of numerous sustainability plans together with a social welfare initiative called Ikea Way.[16] Ambuja Cement, the Indian branch of the Swiss Holcim group, implemented a bottom-up system that entails CSR committees in each production plant. The committees meet once a month and can discuss initiatives that also regard the corporate level, such as the use of alternative fuels. Their suggestions are then taken into consideration within the corporate committees.

3.6 Evaluating CSR projects

Given that the CSR domain includes a broad variety of initiatives, each project requires a specific evaluation to identify its level of priority along with its benefits and costs. A philanthropy project will be evaluated according to social performance indicators (social performance) that might measure the impact on the community,[17] while a project aimed at creating shared value must be evaluated not only in regard to social and environmental impact, but also with respect to the financial impact achieved. Environmental projects, in turn, must be evaluated based on their environmental impact (environmental performance), for example assessing the reduction of pollutants or lower energy consumption, and also with respect to financial performance.

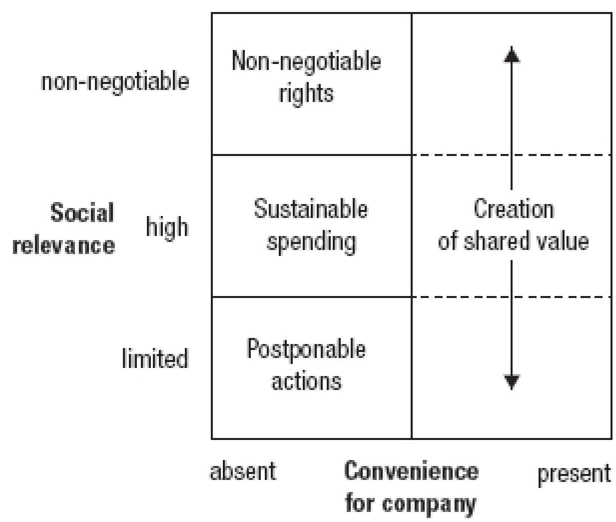
We propose evaluating a project on the basis of two dimensions: social and environmental relevance, and the potential of value creation for the firm.

Social and environmental relevance is the outcome of three analyses: the level of relevance of the project for governance and leadership; the level of relevance of the project for stakeholders; and the level of relevance for the society in general.

Conversely, the potential of value creation results from a cost-benefit analysis. The cost categories can include investments to satisfy socio-environmental expectations, greater costs sustained to satisfy stakeholder requests, and the use of any firm's resources. Benefits of CSR initiatives can be distinguished into economic and non-economic benefits. Among the economic benefits, there could be an increase of revenues or a decrease of costs over the time horizon linked to the project. Non-economic benefits are quite varied. They might be an improvement of a firm's capacity to anticipate future needs or trends; the raising of the level of employee motivation; and the improvement of the firm's reputation.

The CSR evaluation matrix shows the different types of CSR projects on the basis of the two dimensions proposed to evaluate them (Figure 3.3).

Figure 3.3 The CSR evaluation matrix



Source: elaborated from D.J. Collis, C.A. Montgomery, G. Invernizzi, M. Molteni, *Corporate level strategy: generare valore condiviso nelle imprese multibusiness*, 3rd ed., McGraw-Hill Education (Italy) S.r.l., 2012, Figura 14.8.

On the right side of the matrix we place projects able to create shared value, while on the left side we map projects with different priority in terms of social or environmental goals, and for which value creation is limited or absent. *Shared value projects* can be prioritized on the basis of the social and environmental impact they generate, although all they are profitable. *Non-negotiable rights projects* must be carried out whatever it takes, because they often regard rights that are legally protected or ethically non-negotiable. *Sustainable projects* should be carried out as much as possible even in the absence of value creation. *Postponable projects* – having limited social or environmental importance – do not deserve to be undertaken, at least in the short-term. They are typically *nice-to-have* initiatives.

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[2] Porter and Kramer (2011) identify shared value as the sum of the policies and operational practices that strengthen the competitiveness of a firm, at the same time improving the economic and social conditions of the communities in which it operates.

[3] Eccles, Perkins and Serafeim (2012).

[4] Zollo et al. (2015) and Rangan, Chase and Karim (2015).

[5] For a detailed description of the 17 SDGs refer to the website of the United Nations.

[6] The section summarizes the evidence presented in the article by Carroll (2016).

[7] An example is represented by the Arctic Home — Coke & World Wildlife Fund campaign launched in 2011 by Coca-Cola in collaboration with the WWF to protect polar bears. The campaign has collected more than 3 million dollars in donations since its launch, thanks especially to a strong component of digital engagement.

[8] Porter, Kramer (2006).

[9] Visser (2014).

[10] King and Roberts (2013).

[11] Giarratana and Pasquini (2016).

[12] Lojacono and Misani (2016).

[13] Other Italian firms that have become B-Corps are Alessi, a household products manufacturer, and Fratelli Carli, a food firm specialized in the olive oil sector.

[14] CROA (2011).

[15] Many firms do not yet assign the responsibility for CSR to a member of the BoD. There is a preference for identifying a CSR manager who reports directly to the CEO.

[16] The Ikea Way is a welfare program that regards in particular the prevention of child labor and the maintenance of certain standards relating to work conditions in the supply chain.

[17] For example, we can monitor the hours of volunteer work dedicated by a firm’s employees to children who need academic support with the results they have achieved at the end of the school year.

4 Synergies and Resources

by *Paolo Morosetti*

4.1 The concept of synergy

When two businesses owned and managed jointly are more valuable than the same businesses owned and managed independently or separately, there is an incentive – an added value – to combine them. This incentive is called synergy.[1] We can verify the presence of synergies by applying the following test:

$$V(AB) > V(A) + V(B)$$

where V(A) is the equity value of business A when owned and managed independently, V(B) is the equity value of business B when owned and managed independently, and V(AB) is the equity value of the two businesses owned and managed synergically.

Between 2002 and 2014, Campari – a long-lastig player in the spirit industry – announced that it would enter new businesses, precisely the still and sparkling wine, to implement a related diversification strategy with the effect of transforming the portfolio strategy from a single-industry with a multinational orientation model to a multi-industry, marketing driven model

In 2015, that strategy was substantially modified. Campari progressively divested from the still wine by selling off the wineries and product brands bought over time. The degree of diversification was thus reduced, while from that time on, the growth strategy was redirected towards rapid internationalization and a series of entries into new spirits categories, such as rum.

What were the reasons explaining the decision to diversify from spirits to wine? And why did Campari decide to suddenly divest from the still wine business?

Reasoning regarding synergy contributed to strategic decision-making in both cases. The diversification was motivated by the search for synergies in marketing, distribution and sales, while the divestment came from the finding that such synergies were not as significant as expected.

Synergies can be distinguished between financial and operational synergies. Whatever approach to corporate strategy a firm adopts, both categories can always coexist. However, in the synergy approach operational synergies have the upper hand over financial synergies. In the financial approach, the reverse is true.

4.2 Financial and operational synergies

Financial synergies are economic benefits obtainable in financial and tax management. The main categories are the following:

- *Economies of scale in financing*: in multibusiness firms, businesses can benefit from a more competitive cost of capital by exploiting the firm's reputation or its stronger bargaining power vis-à-vis the financial markets.
- *Tax optimization*: in multibusiness firms operating internationally, benefits can be derived from exploiting tax incentives by locating value chain activities in some countries rather than others.
- *Risk diversification*: in composing a portfolio of businesses with imperfectly correlated cash flows, the firm's cost of capital might be reduced. This statement deserves to be further elaborated since risk reduction is debated in theory. On the one hand, the Capital Asset Pricing Model (CAPM) explains that corporate diversification does not reduce systemic risk *per se* in efficient capital markets. While other studies confirm that the simple act of bringing different businesses under common ownership does not create shareholder value through risk reduction. On the other hand, empirical evidence also shows that

risk diversification could generate added value when the firm can diversify at a lower cost to individual owners or can mitigate cyclical fluctuations of profits that could push it into insolvency.[2] Faced with mixed results, we suggest a pragmatic position: risk diversification is not a benefit *per se.* Advantages should be carefully proven case by case.

- *Internal capital market*: given that a multibusiness firm can be compared to an internal capital market where the corporate headquarters allocates resources through the capital expenditure budget, there are circumstances in which internal allocation can be more efficient than the allocation made by the capital markets. First, the internal capital market can create value when leadership has better access to information on different businesses than external players. This helps it to better select investments or allocate resources. Secondly, internal capital market makes it possible for an optimal portfolio to sustain growth by remaining financially indipendent.[3] On the one hand, the optimal portfolio consists of businesses operating in mature industries and businesses operating in industries still in the development phase. On the other hand, the optimal portfolio maintains a balance between the financial flows generated by mature businesses (cash-generating businesses) and the investment needs to sustain businesses still in the development phase (cash-absorbing businesses).

The search for financial synergies has been one of the key drivers in the development of Edizione, the investment vehicle of the Benetton family, whose corporate strategy follows the financial approach. To diversify risk, Edizione has gradually expanded its corporate scope in the past decades: from fast fashion and clothing (United Colors of Benetton), to real estate and agriculture, and to highways, airports and catering (Eurostazioni, Atlantia, and Autogrill). Beyond risk diversification, the holding company has played a substantial role in facilitating the relationships between the main subsidiaries and financial markets to benefit from economies of scale in financing.

Operational synergies are defined as the added value generated by joint operations. Representing a business as a value chain,[4] *joint operations* means connecting value chain activities through a transfer of organizational competences, a sharing of tangible or intangible assets, or a coordination of the competitive strategies linked to each value chain.[5]

For instance, in Campari the distribution of spirit and sparkling wine products share the same platform while marketing activities of the two businesses are connected through the transfer of brand building competences.

From a financial standpoint, operational synergies translate into higher revenues or lower costs, capital expenditures and/or working capital. These advantages derive from:

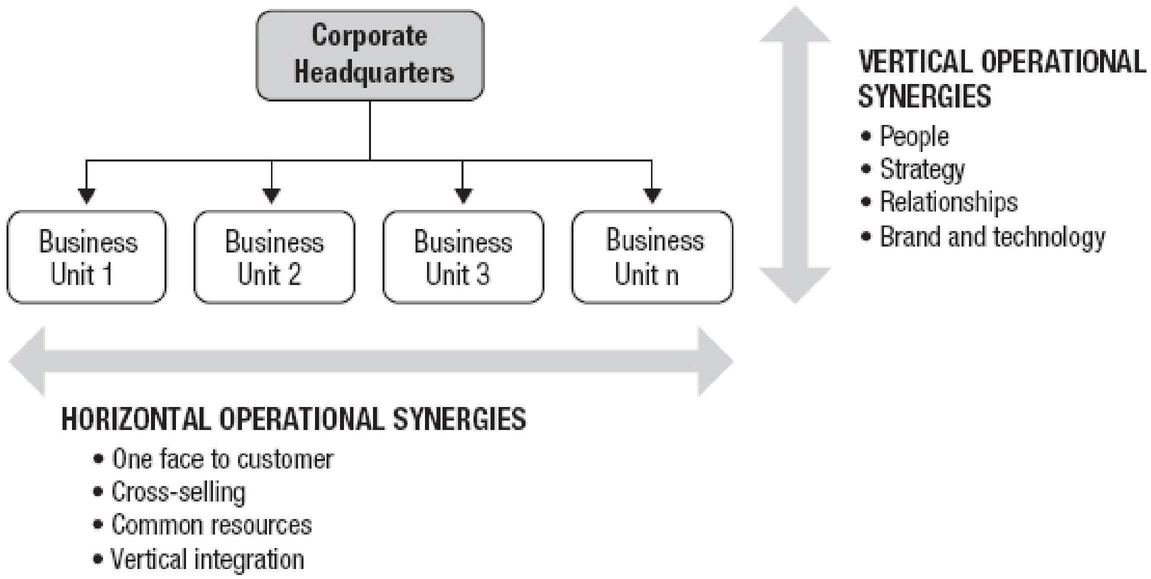
- Economies of scale, economies of saturation of production capacity, economies of experience, economies of scope, and/or transaction cost economies.
- Opportunities to increase the consumer utility through cross-selling and one-stop shopping policies.
- Opportunities to exploit stronger market power towards customers and clients by pooling businesses together.

4.3 Classification of operational synergies

A first classification of operational synergies distinguishes them into one-sided synergies and two-sided synergies. The former identifies situations where a single business draws the majority of benefits from the synergy; the latter identify situations where both businesses obtain an advantage. The distinction between one-sided and two-sided synergies is relevant at the time the performance of a business within a portfolio is evaluated. In the case of one-sided synergies, the results of a unit must be judged also taking into account that it can contribute to the success of other businesses belonging to the firm, although without receiving anything in exchange.

A second classification of operational synergies was developed by Campbell et al.,[6] distinguishing between vertical and horizontal synergies (Figure 4.1). This classification is mainly useful for multibusiness firms which have adopted an organizational structure with a corporate headquarters exercising hierarchical authority over business units (organized as divisions or subsidiaries).

Figure 4.1 **Vertical operational synergies vs. horizontal operational synergies**

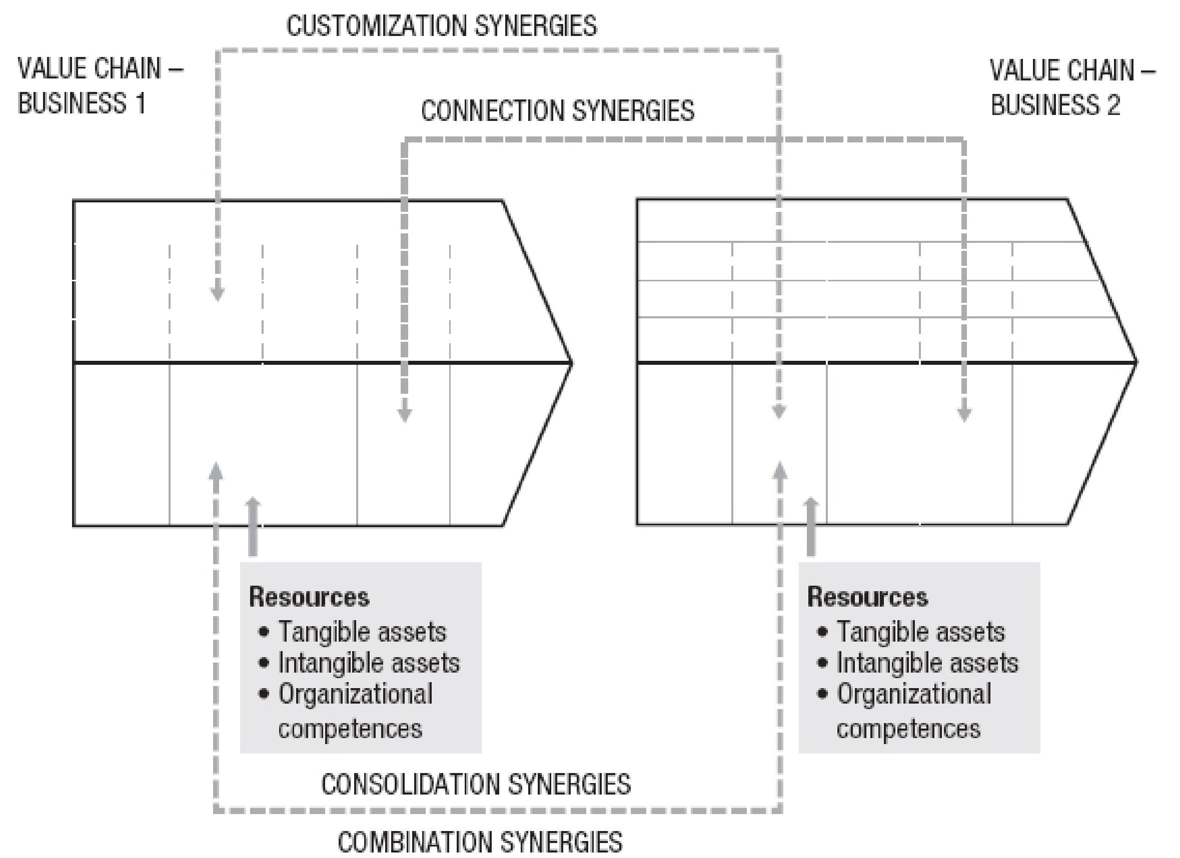


Vertical synergies are the advantages that spring from the hierarchical relationship between corporate headquarters and business units. The former can intervene on the leadership of business units to replace less competent people with people providing greater value (*people decisions*); they can contribute to the processes of strategic management at the business level (*strategy*); they can facilitate the relationships of the managers of the businesses with relevant stakeholders (*relationships*); or they can make a corporate brand (*brand*) or technological resources (*technology*) available to the businesses, to strengthen their competitive advantage.

Horizontal synergies are advantages generated through coordination and integration among business units. Two or more businesses can coordinate sales policies in favor of common customers or clients (*one face to the customer*); implement policies aimed at selling each other the products and services (*cross-selling*); transfer competences or share assets (*shared resources*); or draw benefits from vertical integration (*vertical integration*).[7]

Moving on to a third method of classification, Puranam and Vanneste propose a solution based on the *resource-based view* theory (Figure 4.2).[8] The basic principle is that the implementation of operational synergies entails different arrangements of combinations of resources like aggregating and optimizing the scale of resources to gain in efficiency, pooling resources to extract greater added value, or co-specializing them to implement strategies such as vertical integration.

Figure 4.2 Operational synergies, value chain, resource-based view



Given this variety, operational synergies can be divided into four conceptual categories (Table 4.1):[9]

- *Consolidation synergies*. These synergies can be obtained by *aggregating and optimizing* the stock of *similar resources* to exploit economies of scale or economies of scope. For example, when a bank acquires a competitor, it can opt for the use of a single information system at the group level, achieving economies of scale in the management of information systems.
- *Combination synergies*. These assume *pooling similar resources* to improve the bargaining power of the firm towards clients, suppliers, or key stakeholders. Pooling does not require an optimization of the stock of resources. In food industry consolidation, for example, one of the drivers has been the search for stronger market power with respect to large-scale distribution chains and the new global e-commerce players.
- *Customization synergies.* These synergies are implemented by *co-specializing resources* linked to the value chains of the different businesses engaged in the synergy.

  For example, when Google acquired YouTube, it carried out a series of actions in the value chain of the search engine and in that of the video sharing platform so that it would be simpler to include YouTube videos in the results of Google searches and to better monitor the behavior of users in order to boost advertising revenues. Customization impacts economies of scope or transaction costs economies.
- C*onnection synergies.* These assume *pooling non-similar resources* among value chains of the different businesses engaged in the synergy. For example, each time a cross-selling policy between two businesses is promoted, a connection synergy is created. The same thing happens when multiple businesses are combined to realize a "one-stop-shopping" policy or when they coordinate their respective competitive strategies. Connection synergies mainly exploit market power, economies of scope or transaction costs economies.

Table 4.1 Variety of operational synergies

	High similarity in resources to coordinate/transfer/share	**Low similarity** in resources to coordinate/transfer/share
High impact	Consolidation synergies	Personalization synergies

of organizational changes to coordinate/transfer/share resources among value chains		
Low impact of organizational changes to coordinate/transfer/share resources among value chains	Combination synergies	Connection synergies

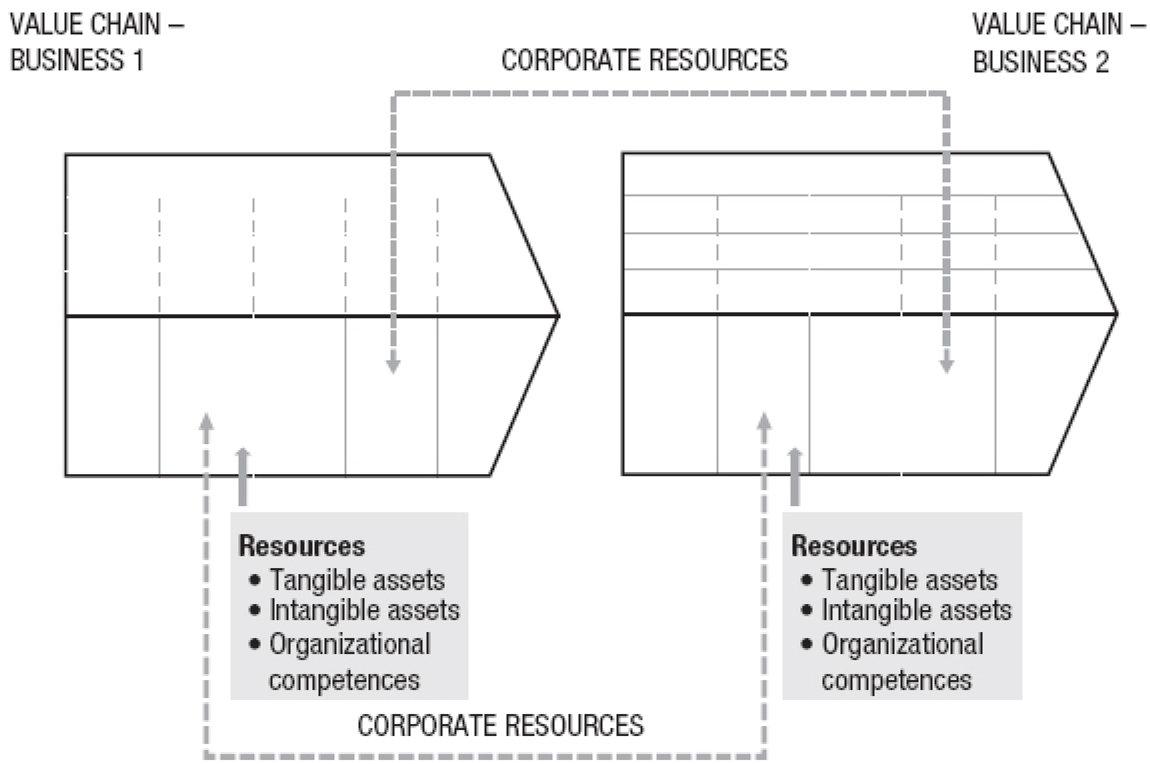
Source: adapted by authors based on P. Puranam, B. Vanneste, *Corporate Strategy. Tools for Analysis and Decision Making*, Cambridge, Cambridge University Press, 2016.

4.4 From synergies to corporate valuable resources

The resource-based view not only makes the concept of operational synergies easily intelligible, but also allows for developing two other notions.

- *Corporate resources:* they are tangible assets, intangible assets, or organizational competences used in the value chain of two or more businesses owned by a firm (Figure 4.3). Resources not classified as corporate, are defined as *business resources*.
- *Corporate valuable resources* (or resources with high strategic importance): they are corporate resources that allow for achieving competitive advantages in businesses where they are applied. This implies that they are instrumental to build a corporate advantage.

Figure 4.3 **Graphic representation of corporate resources**



To discover corporate valuable resources, we can follow a process divided into three phases:

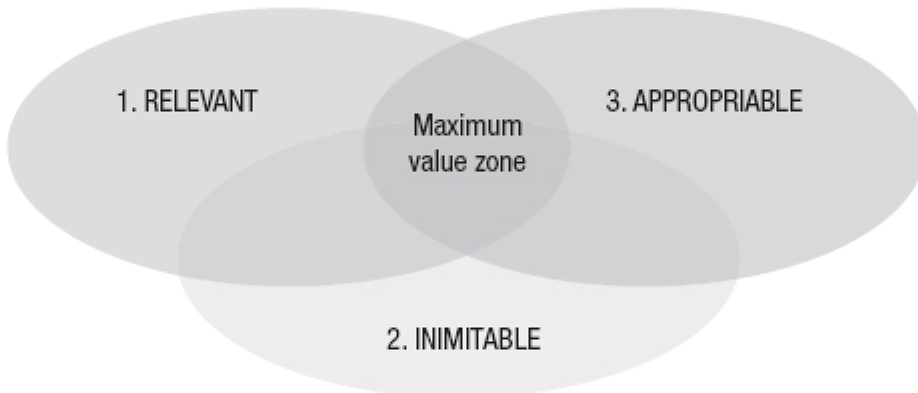
1. Analysis of the resources at the business level.
2. Identification of the valuable resources at the business level.
3. Identification of the corporate valuable resources.

The first phase of the process entails analyzing the value chains of businesses owned by the firm and the resources they use to operate. Per each value chain activity, the associated resources are distinguished into tangible assets, intangible assets, and organizational competences.

The second phase of the process entails identifying the business valuable resources, i.e., that subset of resources that play a key role in building a competitive advantage and maintaining it over time. But what makes a resource valuable? Building on the framework of Collis and

Montgomery,[10] a valuable resource meets three criteria: relevance, inimitability, and appropriability (Figure 4.4).

Figure 4.4 What makes a resource valuable?



Source: autohor's elaboration based on D.J. Collis, C.A. Montgomery (2008), "Competing on Resources," *Harvard Business Review*, July-August.

A resource is *relevant* when it contributes to satisfying the critical needs of the customer better than competitors. In other words, a resource is relevant if it is one of the drivers allowing to earn a cost leadership position or to deliver unique selling points within a differentiation strategy.

A resource is *inimitable* when it is not easily marketable nor can it be replicated by competitors economically. In addition, it can also not be substituted with others to reach the same goal (Box 4.1).

Box 4.1 The basis of the resource-based view

Classification of resources

According to Collis and Montgomery, resources are:

- Tangible assets.
- Intangible assets.
- Organizational competences.[11]

Tangible assets are factors of production of a physical and financial nature. They include, for example, raw materials, mineral and oil reserves, production structures, lands, telecommunication networks, points of sale, and available cash. These resources are the simplest to identify given that they are traditionally entered into financial statements among the items that make up the balance sheet assets.

Intangible assets are factors of production of an immaterial nature. They include factors such as firm reputation (reputational assets), brand equity, networks of relationships functional to developing the business (social and relational capital), information relevant to running business activities (e.g. technology know-how) and various forms of intellectual property like know-how, patents, copyrights, trade secrets, and trademarks. Unlike tangible assets, intangible assets are often not recorded in the financial statements or are not adequately valued. In addition, they may acquire value with the passing of time following their repeated use (consider the process of building brand equity).

Organizational competences[12] are embedded in a firm's routine, processes and culture, and are a "firm's capacity to deploy resources for desired end results"[13] by combining tangible assets, intangible assets, and people or human resources. By their nature, competences are the result of a process of learning. Examples of this kind of resources are production, sales, marketing, mergers and acquisitions, business development, and logistics competences.

It is important to observe that the classification proposed by Collis and Montgomery does not expressly cite human resources as a category, unlike what other scholars propose.[14] The reason for that choice is to be sought in the fact that human resources are considered by American scholars indirectly, namely when they analyze organizational competences. That approach is consistent with what has been proposed by other academics who believe that human resources are primary stakeholders and not merely factors of production.[15]

Main theoretical assumptions

The resource-based view sets the goal of analyzing the single firm considered as *unique* and asks how the organizational processes of acquisition and exploitation of resources allow a firm to obtain both a competitive advantage and a corporate advantage.

There are two principal assumptions behind this theory:

1. Within an industry, the distribution of financial performance among competitors is not uniform since resources are not equally distributed among firms.
2. Within an industry, the differences in financial performance among competitors can persist over time since resources are not perfectly mobile, imitable, and/or substitutable.

The first assumption states that only the firms that control *certain* resources within an industry (namely *valuable* resources as described in the next section) may achieve a competitive advantage measured by financial results above average, while those who do not have access to such resources suffer from a competitive disadvantage. The lack of uniformity in the distribution of resources is associated with phenomena of scarcity or rarity of resources.

The second assumption explains the reasons why a successful firm can maintain its competitive advantage over time (the so-called strategic sustainability). Those reasons were identified as the existence of *protection mechanisms* or *isolation mechanisms* that prevent third parties from seizing the profit or rent generated by these resources for the firm.

It's worth noting that the resource-based theory focuses on *Ricardian rent:* profits generated for the firm thanks to resource superiority. This type of rent has to be theoretically separated from *monopoly rent,* based on market power, or *Schumpeterian or entrepreneurial rent,* which arise from innovation.

Protection mechanisms

Imperfect mobility, imperfect imitability, and imperfect substitutability are the three mechanisms of protection. In the presence of *imperfect mobility*, the exchange or negotiation of resources between firms is hindered, if not precluded, by one or more of the following factors:

- *Information asymmetries*. When a rational buyer is unable to gather information *ex ante* on the characteristics of the resources she intends to acquire, it is unlikely she will venture into a transaction because she will not be able to judge the negotiating conditions that are offered. This situation occurs more frequently when the transaction regards an intangible asset or an organizational competence. For example, the evaluation of the quality and possible applications of technical knowledge is objectively difficulty *ex ante*. This is a reason why technology-transfer is so difficult to negotiate.
- *Complementary relationships between resources and the organizational context*. If the value of a resource depends heavily on the organizational context in which it was developed and is used, it is unlikely that such a resource can be the subject of a transaction as a stand-alone factor because it would lose much of its value once uprooted from its original context. Think of a firm that wants to obtain an organizational competence in production. It is unlikely it will settle for buying only a manual of procedures if the value of the competence depends on the combination of routines, procedures, people and culture.
- *Difficulty of geographic transfer*. Some resources are not mobile because their value depends on the geographic context in which they are developed and exploited. For example, a brand in the food industry linked to Made in Italy cannot easily be sold to an Asian firm that wishes to use it to market goods produced in its country of origin.

As for *imperfect inimitability*, there are some factors that prevent imitators from copying the valuable resources controlled by market leaders (or incumbents):

- *Causal ambiguity*. When a imitator is unable to codify the nature of the cause-effect relationships that connect the resources with the extent of the firm's success, we have a situation of causal ambiguity that does not allow for determining what are the most important resources to be imitated, or how to imitate them. This happens because they are used in complex organizational contexts where the routines and procedures are not codified in full or where the tacit behavior of people makes the difference in determining the final result. Otherwise, this comes about because a resource is combined with others inside of a process, with the consequence of not succeeding in distinguishing clearly if and how much it contributes to reaching the final result.

- *Path dependence*. The path or process of development of a resource through history cannot easily be codified and imitated. For example, if a chemical company offers unique chemicals highly appreciated by the end client, resulting from a learning-by-doing process, the late comer will be hard pressed to imitate them, because it will not be able to replicate ex-post the temporal sequence of errors, intuition, attempts, continuous improvement, and knowledge development. Even when replication or imitability is theoretically viable, it is possible that this may occur only with disproportionate costs. In these circumstances, imitators are disadvantaged because they cannot replicate the asset mass efficiency reached by market leaders and they suffer from time compression diseconomies.[16]
- *Economic deterrence*. When the incumbent threatens imitators with taking a series of countermeasures to make the attack economically not convenient (i.e., threats of retaliation), there is an economic deterrence preventing the replication.
- *Uniqueness of the resource*. Some resources cannot be imitated because they are available in limited physical quantities in nature. Consider the most prestigious locations in the main luxury neighborhoods of Milan, Paris, and New York, for example. Since the extent of their display surfaces is limited, those who do not possess them will suffer from a disadvantage if the goal is to become a luxury firm.

Lastly, *imperfect substitutability* occurs when a resource cannot be substituted with another one in order to achieve the same goal. For example, a patent protecting a chemical or a process technology may not have any substitutes in nature. As long as the patent grants protection, the firm controlling such intellectual property can gain a competitive advantage and extract value from the resource while rivals either they have to postpone their ambitions or invest to discover innovative solutions.

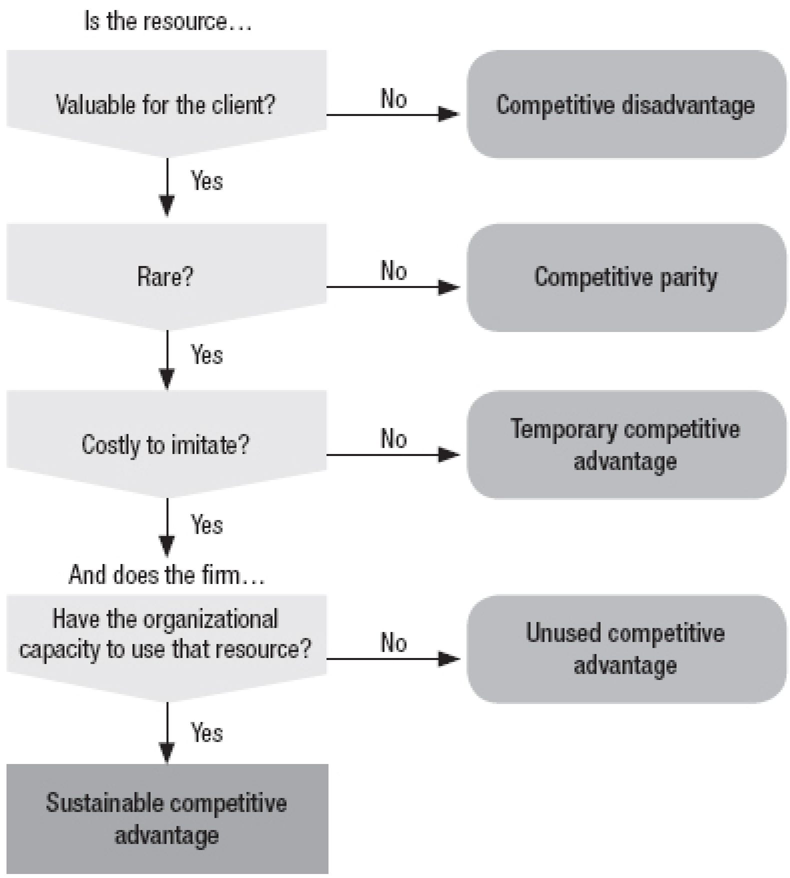
Lastly, a resource is *appropriable* when the firm has the possibility and organizational ability to benefit from all of the rents deriving from its exploitation. This implies that the rent is not expropriated by clients, suppliers, employees or distributors. Moreover, the firm is able to use the resource efficiently, not dissipating the potential profit due to poor organizational capacity or mismanagement.

The Apple brand is a crystal-clear example of a valuable resource. It is relevant because it successfully differentiates Apple’s offer from that of competitors. Consumers buy the brand, not only the technology integrated into the goods and services, and they are willing to pay a premium price for it. It is hard to imitate, since it is one of the brands with the greatest brand equity in the world, due to a history of success that by now spans decades. Lastly, the rent due to the use of the brand is almost entirely kept by the Apple group.

There are alternative models to define if a resource is valuable. According to Barney, a resource has this attribute if it is relevant for the client (Valuable), rare (Rare), cannot be imitated (Inimitable), and cannot be substituted (Non-substitutable).[17] Together, the four proprieties make up what is known as the "*VRIN framework*." In more detail, a resource is relevant if it allows for seizing a market opportunity and building a competitive advantage. It is rare (or scarce) if it is controlled by a small number of competing firms. It is inimitable if the competitors are not able to acquire it on the market or develop it internally from scratch at advantageous economic conditions. It is non-substitutable when no other technical and organizational solutions exist to pursue the same application.

Over the years, the VRIN framework evolved, transforming into the "*VRIO framework*." The characteristic of being Non-substitutable was included in the concept of Inimitable, and a new property was identified: *Organized to capture value*. In essence, the firm must demonstrate a specific organizational capacity to be able to effectively and efficiently use these resources in the value chain (Figure 4.5).

Figure 4.5 **VRIO framework (Valuable, Rare, Inimitable, Organized to capture value)**



Source: developed by authors based on F.T. Rothaermel, *Strategic Management: Concepts and Cases*, New York, McGraw-Hill/Irwin, 2012.

A comparison between the approach proposed by Collis and Montgomery and that of Barney indicates that the concept of "relevance" of the former refers to the properties of "value" and "rare" of the latter; that of "inimitability" corresponds to the characteristic of "inimitable;" while "appropriability" recalls the notion of "organized to capture value."

Coming now to the third and last phase of the process of identification of corporate valuable resources, the latter can be distinguished by simply applying the definition previously illustrated (Box 4.2).

Box 4.2 **Corporate valuable resources in a multibrand group: an example**

The Alfa firm operates in four businesses: retail distribution of food products; retail distribution of consumer electronic products; retail distribution of sports products; and retail distribution of products for bricolage and gardening. Although the corporate brand has a long tradition and is widely recognized by the public, each distribution chain uses its own retail brand to compete in their respective markets. **Figure 4.6** schematically shows the set of corporate resources and sets of business resources of the Alfa firm, while **Figure 4.7** shows the division of the corporate and business resources into those valuable and not valuable, applying the methodology presented in Paragraph 4.3.

Figure 4.6 **Alfa Firm: corporate resources vs. business resources**

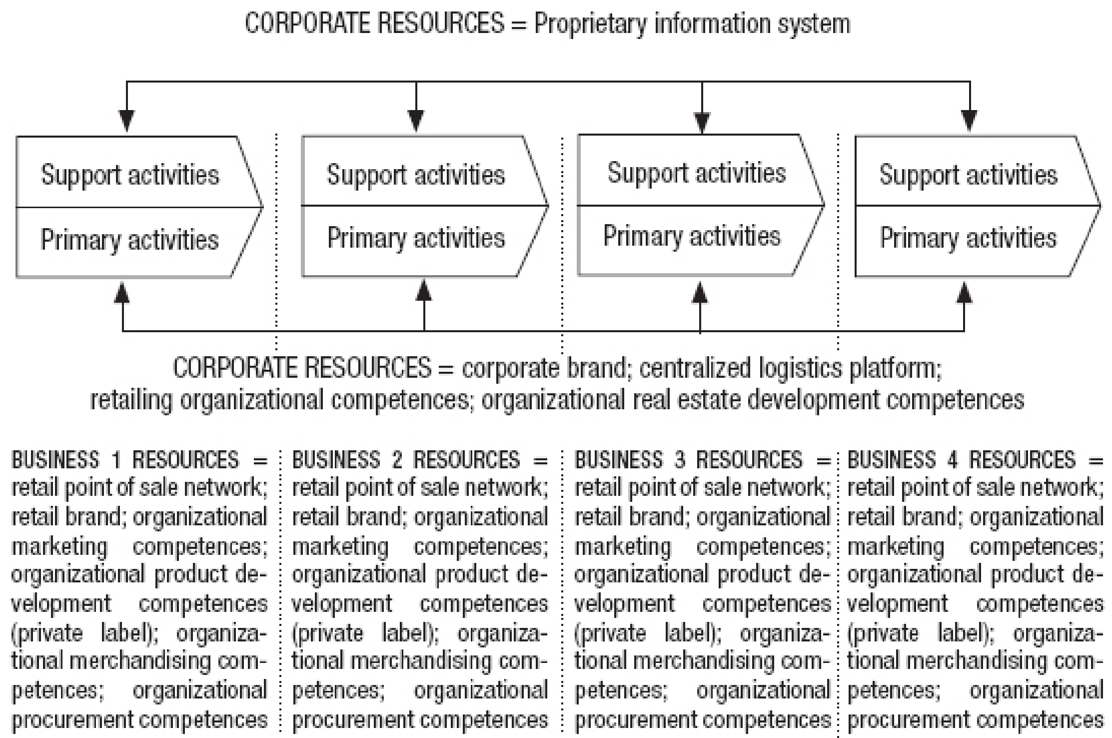


Figure 4.7 **Alfa Firm: valuable and non-valuable resources**

	Resources used exclusively by one business	Corporate resources
Valuable resources	• Retail point of sale network (tangible asset) • Retail brand (intangible asset) • Marketing competences • Product development competences (private label)	• Corporate brand • Centralized logistics platform (tangible asset) • Retailing competences • Real estate development competences
Non-valuable resources	• Merchandising competences • Procurement competences	• Proprietary information system (intangible asset)

Returning to the example of Apple, the brand is a corporate valuable resource, being used in all businesses in the portfolio of the Cupertino group to earn a competitive advantage and build a corporate advantage. In the case of Campari, the distribution platform acts as a corporate valuable resource, as do brand building competences.

To conclude, we note that the identification of corporate resources adopts the value chain as a point of reference for the analysis, not the organizational structure of the firm. This means that it would be a mistake to confuse them with centralized functions or the units forming the structure of corporate headquarters. A centralized function certainly presides over a corporate resource, but a multibusiness firm can use other organizational mechanisms to implement synergies as seen in the previous classifications.

4.5 Negative synergies

Although the concept of synergy has an intrinsic positive connotation, in business practice the joint ownership of businesses can translate into negative results, indicated as "negative synergies."[18]

Some recurring cases exemplify this phenomenon, such as that of "brand dilution." A brand that is historically associated with a particular business or product line can be exploited incorrectly to enter new competitive fields with the result of dissipating much of its original value (brand equity). The method of management of the Pierre Cardin brand, for example, shows this type of risk. Starting in the 1980s, the brand was licensed for 800 products, including toilet seat covers, with the result of depleting most of the brand equity constructed in upmarket fashion.

A second example of negative synergy can manifest itself in the choice of vertical integration through an acquisition. If a firm moves forward, the acquired business could have difficulty continuing to operate with its traditional suppliers, given that they will become competitors of the vertically-integrated group. If the integration goes upstream, the acquired business could have difficulty with its old clients as they will become competitors of the vertically-integrated group.

A third example of negative synergy can arise when the portfolio strategy aims to create a multibrand group within the same industry through acquisitions. Given that each brand in the portfolio can be considered similar to a business, it is not rare to see that some of the starting brand's clients decide to no longer have business relations with the new group that is formed. The reason for this behavior depends on their unwillingness to have as a supplier a group serving their direct competitors, although through other brands. There is a fear that sensitive information can flow between the group's organizational units, between one brand and another, causing economic harm.

The fourth and final example of negative synergy is associated with the organizational complexity related to the execution of operational synergies. Unfortunately, implementing synergies might risk creating bureaucracy, slowing down the decision-making, and compromising to align multiple parties and mediate their needs and interests. Demotivation can also spread while the firm risks losing entrepreneurial orientation and enthusiasm to innovate.[19] In this event, the *net* economic effect on joint operations can translate into a negative synergy rather than a (positive) synergy.

[1] See Collis et al. (2012); Porter (1987); Puranam and Vanneste (2016). We recall that a corporate strategy is successful only if the amount of synergies is enough to pass the better-off test and the best-alternative test (see Chapter 1).

[2] Grant (2015).

[3] The BCG portfolio matrix illustrates the functioning of an internal capital market: see Reeves et al. (2014).

[4] A value chain represents the sum of activities that must be carried out to produce a product or a service and bring it to the client (or customer). The activities of the value chain are divided into: (i) primary activities (incoming logistics, production, outgoing logistics, marketing and sales, after-sales assistance), that directly contribute to creating value for the client; (ii) secondary or support activities (infrastructure activities, human resources, technology development, procurement), that indirectly contribute to the creation of value. On the value chain, see Porter (1985).

[5] The resources are tangible assets, intangible assets, and organizational competences. Box 4.1 provides further discussion of the issue.

[6] Campbell et al. (2014).

[7] See Chapter 14.

[8] The theoretical outlines of the resource-based view are illustrated in Box 4.1.

[9] Puranam and Vanneste (2016).

[10] Collis and Montgomery (2008).

[11] Collis and Montgomery (2008).

[12] We use the terms capability and competence interchangeably.

[13] Helfat, Liberman (2002).

[14] Grant (2015).

[15] Airoldi, Brunetti and Coda (2005).

[16] Grant (2015).

[17] Barney (1991).

[18] Puranam and Vanneste (2016).

[19] In his first work on the subject of corporate strategy, Porter (1987) warned against the costs that are generated when interrelations, i.e., synergies, are created between value chains. See Chapter 7 of this book.

5 The Choice of the Core Business

by *Paolo Morosetti*

5.1 The concept

The story of Enel in the telecommunications industry is a straightforward example of how a business can evolve from core to non-core over time; and how this evolution has substantial implications at the corporate level.

In the mid-1990s, Enel – today an integrated electricity and gas distribution multinational company headquartered in Italy – diversified into telecommunications, with the goal of transforming itself into an international multi-utility: a company offering a wide range of services and products in relation to public utilities.

This model gained popularity during the nineties following the privatization of many state-controlled monopolies and the liberalization of public utility markets in the European Union such as energy, water, telecommunications, waste and the environment. It was thought that a multi-utility approach would create value in three main ways. First, incumbents – the old state-controlled monopolies – could avoid falling into the trap of a domestic decline in markets becoming increasingly competitive. Second, they could exploit untapped growth opportunities in potentially related industries where technological development was faster-paced and able to open new and attractive industry segments, such as in telecommunications. Third, they could face markets with an integrated offer of good and services to take advantage of operational synergies such as cross-selling policies or capital and operating expenditure optimization related to the deployment and management of distribution and sales networks.

Enel's first venture in telecommunications was the launch of Wind in 1997, in partnership with France Telecom and Deutsche Telecom. In 1998, Wind won the bid to obtain a mobile telephony license and soon became Italy's third mobile provider. In 2000, Enel took the role of the majority shareholder of Wind while Deutsche Telekom dropped out. In the same year, Infostrada, one of the most important fixed-line providers in Italy, was bought by Vodafone from Enel and then was merged with Wind, which became the second player in the Italian telecommunications market. At the end of this merge, the Enel's shareholding in Wind reached 73.4%.

Until the beginning of the 2000s, we can assume the leadership undoubtedly judged the telecommunications to be a *core business*: a strategic holding in which to invest significantly. Then, a drastic change took place in conjunction with the renewal of the Board of Directors in 2002. The new Chief Executive Officer, Paolo Scaroni, revisited the corporate strategy with the effect of selling-off the majority stake in Wind in 2005, and divesting the remaining portion in 2006.

In 2005, Paolo Scaroni commented: "With the sale of Wind we have completed the disposal of all businesses unrelated to our core activities in electricity and gas, in accordance with the strategy announced three years ago. The exit of the telecommunications business from the Group's activities will enable Enel to focus its growth on energy in Italy and abroad."[1]

Over nearly ten years, the story of Enel shows us an upside-down shift in strategic thinking, confirming three crucial points in the debate about the core:

1. Core is an attribute that certifies the *strategic importance* of a business and its priority in resource allocation.
2. Core is not an attribute forever.
3. The attribution is a managerial choice, not an outcome of an algorithm. The leadership assigns the attribute during portfolio planning.

But what does *strategic importance* mean? That is the point of discussion in theory and practice and the subject of the next sections. First of all, we classify the main methods for defining the core into three categories. Then we propose our approach and reflect on the managerial implications.

5.2 The historical method

According to the historical method, the core business is identified as the first business the firm invested in or the pioneering activities that marked the initial phase in the firm's life-cycle.

This approach protects tradition and recognizes the great effort and sacrifice of people who created the firm. It also cares for the values and guiding principles that led to making certain successful decisions in the past, and the organizational competences learned by doing over time.

Although being easy to apply, this method has the great limit of providing the leadership with an incentive to look towards the past – tradition – with the risk of not sufficiently prodding the firm to continuously seek new business opportunities. In addition, it creates an invisible and dangerous obstacle or inertia in decision-making processes, which sooner or later prevents strategic innovation.

Of course, the simplicity of the model and the possibility to pay a tribute to the achievements of charismatic entrepreneurs and leaders explain why it is largely used in small and medium-sized firms with family ownership.

5.3 The quantitative method

The quantitative criteria method associates the attribute of "core" with those businesses that satisfy a quantitative parameter or metric better than others over a certain span of time.

For example, core businesses can be those that participate the most in total revenues generated in an accounting period. Other parameters that can be adopted include: operating income, cash flow, value creation, capital employed, gross asset value,[2] or market shares.

Jack Welch, the memorable CEO who led General Electric for over twenty years, distinguished businesses in which to invest (and thus core businesses, following the jargon we are using in this book) from those from which to divest (non-core), using a quantitative criterion: a business is core if it is the #1 or #2 competitor in its industry.[3]

The advantages of the quantitative criteria method are its ease of use and the possibility to introduce a dynamic perspective in the analysis. If over the years a business has not been able to contribute more than others to the selected parameter, it would automatically be placed among the non-core businesses.

This method is not without disadvantages. First of all, the possibility to use alternative parameters to choose the core risks triggering lively discussions within the organization aimed at placing certain businesses in a better light than others, as a function of the metric used. Think of the case of a unit that is the largest contributor to the firm's revenues, but not to its operating result: it will be classified as core or non-core precisely as a function of the metric used.

Secondly, this method treats businesses as stand-alone entities with the risk of underestimating their strategic relevance in building operational synergies. For example, a unit defined as non-core according to a quantitative criterion could actually be the "organizational place" in which a corporate valuable resource is developed. So why not include this business among the principal ones in which the firm should continue to invest, at least selectively?

Thirdly, when a value creation parameter is used, other specific distortions can arise. For example, take the economic value added (EVA) parameter calculated as follows:

$$EVA = (ROCE^* - WACC) \times CE_{to}$$

where:

– EVA = Economic Value Added of the business
– ROCE* = Return on Capital Employed
– WACC = Weighted Average Cost of Capital for the specific business
– CE_{to} = Capital Employed in the business at the beginning of the period.

A judgment based on EVA leads to assigning the attribute of core to the units that absorb a significant portion of the capital and that achieve greater profitability than the weighted average cost of capital. This means that capital intensive businesses will tend to automatically be preferred over others because they can count on a larger base of capital to generate a flow of value creation. To the contrary, non-capital intensive businesses will never be core, due to the distortion that accompanies the math underlying the calculation of the EVA. The same conclusions could have been reached by taking other value creation metrics, such as those based on free cash flows.

5.4 The qualitative method

Core businesses can be determined also by considering qualitative criteria. According to Porter, the core business consists of units that:

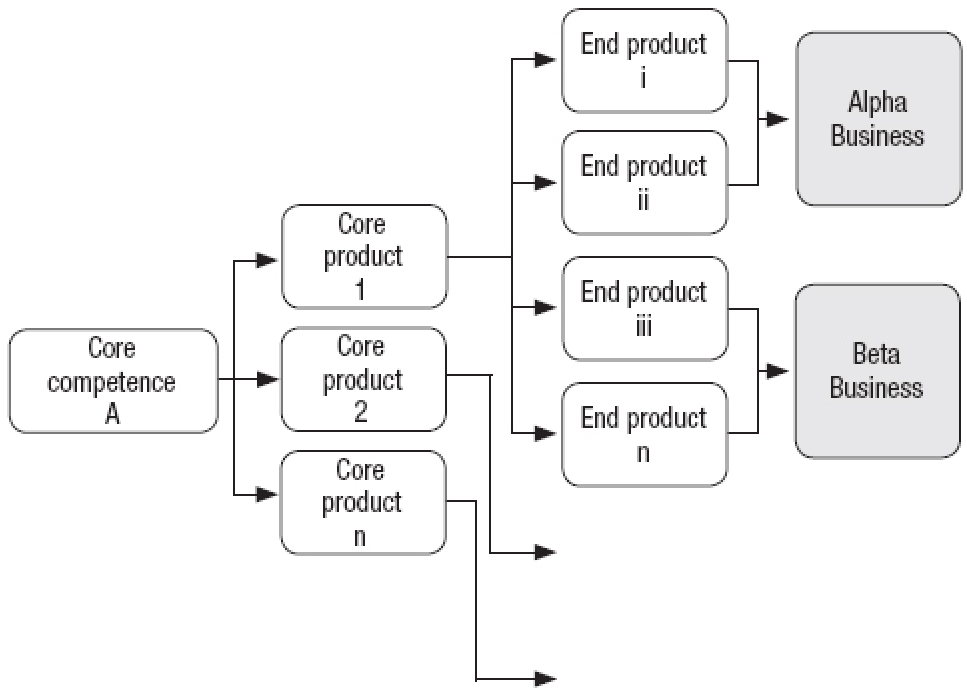
> are in an attractive industry, have the potential to achieve sustainable competitive advantage, have important interrelationships with other business units, and provide skills or activities that represent a base from which to diversify.[4]

The assumption that the core comprises businesses that have or can achieve a competitive advantage *and* that are interrelated with others to build a corporate advantage is picked up on and discussed also by Prahalad and Hamel, who contributed to the debate by assigning the attribute of core to businesses in which core competences are used. The latter are defined as:

> the collective learning in the organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies.[5]

The notion of core competences deserves to be further investigated because their relation with businesses is mediated by two factors: core products and end products. Core products are goods or services produced directly through the use of core competences. To the contrary, end products are goods and services destined to an end market that have been developed and produced using one or more core products (Figure 5.1).

Figure 5.1 **Core competence, core product and end product**



For example, an automotive firm which has a core competence in motor engineering can develop a diesel engine (a core product) that is installed on motor vehicles belonging to different offer lines (end products): from sedans to SUVs. Following this thread, a car platform can be classified as a core product if used for the manufacturing of automobiles with different brands. This is what happened in the Volkswagen group, where car platforms are shared by various brands such as Audi, Volkswagen, Skoda, and Seat.

It is clear that the concept of core competences is linked to one of the interrelationships proposed by Porter, which is in turn equivalent to the one of synergies as we outlined in the previous chapter.

A third contribution to define the core was developed by Zook,[6] who described a business as core when:

- It competes in an industry with both an attractive profit pool[7] *and* growth potential.
- It serves core customers that are profitable and loyal to the firm.

- It benefits from strategic differentiators, that are instrumental to beating competitors in the marketplace and obtaining a competitive advantage.[8]
- It uses core capabilities understood as "a strong and unique set of linked capabilities […] combined into activity systems."[9]

In essence, Zook rephrases the concept of core competence into the form of core capability, further develops what has already been suggested by Porter, and introduces an original nuance in the debate by linking the core to businesses that have a potential for growth.

There are essentially two advantages of this method: ease of use, and the ability to foster more responsibility in leadership because more discretion is maintained in selecting in which businesses the firm should invest *to grow,* in keeping with its vision.[10] As for disadvantages, the principal one is the way to exercise managerial discretion. Superficial analyses, not corroborated by a sufficient amount of data and information, and not based on methodologically correct evaluations and judgments, can lead to mistakes. Even worse, managerial discretion can produce unethical behavior such as the manipulation of reality aimed only at maximizing the interests of the leadership, not of the firm.

5.5 How to choose

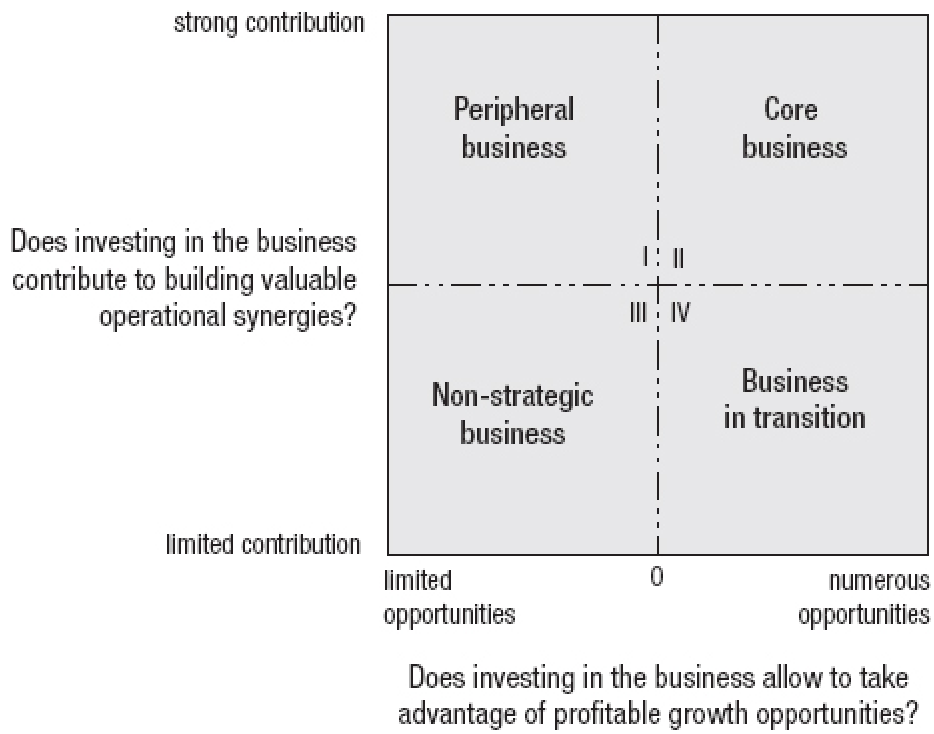
Building on previous arguments, we have developed two proposals to define the core. For firms adopting a synergy approach, the core includes businesses meeting two criteria:[11]

- They contribute to building operating synergies based on corporate valuable resources.
- They allow for seizing profitable growth opportunities in industries that are attractive or can become attractive following transformations underway.

To the contrary, for firms adopting a financial approach, the core businesses are those which most contribute to the firms' gross asset value.

Both proposals have managerial implications that are worth investigating. In the case of the synergy approach, the two criteria advanced can be used to draw a matrix as reported in Figure 5.2 (The Core Matrix). The quadrants identify four situations: core businesses; peripheral businesses; non-strategic businesses; and businesses in transition. The last three comprise different types of non-core.

Figure 5.2 Core matrix (synergy approach to corporate strategy)



Investment in core businesses (II) should be prioritized. Such businesses present growth opportunities and benefit from operational synergies based on corporate valuable resources. In addition, their development should let the firm realize its vision. Prioritizing core businesses in resource allocation is thus entirely consistent with the business logic and the added value logic.[12] Campari, for example, declares that "spirits is the core business." This implies that all businesses within the spirits industry – such as vodka, rum, bitters, liquors, or aperitifs – belong to the core.

Peripheral businesses (I) are the units to which the firm's resources should be allocated selectively, since they don't provide leeway for profitable growth. Selective allocation means that investments will be limited either to preserving at least the competitive parity with rivals or to letting the core business benefit from operational synergies. In the case of Walt Disney, core businesses are the theme park business, studios, and media networks, while the Disney Cruise Line can be classified among the peripheral businesses. Such a business helps to build operational synergies because it drives the flow of clients who will visit the theme parks and contributes to strengthening the group's brand equity. However, it does not represent a priority in resource allocation for the leadership, that certainly does not aim to compete with market leaders as large as Carnival and Royal Caribbean.

As for non-strategic businesses (III), these are units for which a divestiture should be evaluated[13] as soon as the market conditions are suitable to carry it out. The allocation of resources to these units must be as limited as possible in order to avoid destroying value. Of course, for these businesses the criteria of the better-off test and of the best-alternative test[14] are never both satisfied. In 2005, Amplifon sold its business of distribution of orthopedic and traumatology products because it was no longer considered to be strategic. The diagnostics business met the same fate, being sold off in 2006.

Lastly, businesses in transition (IV) are units where resources are still to be allocated selectively as long as the leadership does not decide to bring those businesses into the core area or prepare them to be divested.

In 2017, Fiat Chrysler Automobiles (FCA) controlled Magneti Marelli, one of the global players in automotive hi-tech systems and components whose market positioning was rated strong. In the Core Matrix, this business could be placed into the quadrant of business in transition because it did not contribute to building relevant operating synergies, although market opportunities were favorable. This conclusion was confirmed by Sergio Marchionne, the FCA group CEO, who declared in 2017 that Magneti Marelli could have been sold to a competitor or become a separate entity, with shares distributed to FCA's existing shareholders. What happened next? In 2018, FCA sold Magneti Marelli to the Japanese automotive company Calsonic Kansei to create one of the world's largest auto parts firms.

Turning to the managerial implications for firms with a financial approach to corporate strategy, we must recognize that the notion per se is very distant from the way of thinking of the business community, and that a core business is not automatically one where to prioritize investment. In these firms, decisions depend more on other motivations, such as:

- The search for balance between cash-generating and cash-absorbing businesses, to not depend excessively (or completely) on debt markets.
- The search for growth opportunities to support development and investment in mature businesses to stabilize the organization and preserve continuity.
- The search for risk diversification regarding country, technology trends, and currency.
- The search for balance between the risk-return expectations of ownership and the need to invest in certain businesses, whether to ensure cohesion between shareholders or for reasons linked to the corporate social responsibility strategy pursued by the firm.

These points will be further analyzed in Chapter 8, when we examine the financial approach in portfolio strategy.

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[1] https://www.enel.com/media/press/d/2005/05/enel-sells-wind-to-weather-

[2] The Net Asset Value (NAV) is the total value of assets net of the gross debt of the holdings system. The sum of the total value of assets is defined as Gross Asset Value (GAV). Gross debt is the total amount of the financial debt of the holdings system.

[3] Bartlett and Wozny (2005).

[4] Porter (1987), p. 58.

[5] Prahalad and Hamel (1990). The concept of core competence is consistent with that of organizational competences defined in Chapter 4. Organizational competences regard any activity of the value chain, unlike Prahalad and Hamel's approach, that associates core competences principally with the world of *operations* and research and development.

[6] Zook (2007).

[7] A profit pool can be defined as "the total profits earned in an industry at all points along the industry's value chain;" Gadiesh and Gilbert (1998).

[8] The concept of differentiation used in Zook's work (2007) is similar to that proposed by Porter in the celebrated article "What's Strategy" (1996).

[9] Zook (2007).

[10] Coda (1998); Collins and Porras (1996).

[11] This proposal is founded on the resource-based view (Barney 1989; Collis and Montgomery 2008; Prahalad and Hamel 1990); on the theoretical framework underlying the strategic analysis of an industry (Porter 1996; Zook 2007); and on the contributions concerning synergies (Campbell et al. 2014; Goold and Campbell 1998; Porter 1987).

[12] See above, Section 1.2.

[13] For further discussion of divestitures, see Chapter 6.

[14] See above, Section 1.6.

6 Scale and Corporate Scope

by *Paolo Morosetti*

6.1 The concept

Decisions regarding portfolio strategy are divided into:

- Decisions about allocating resources to each existing business.
- Decisions about entering new businesses.
- Decisions about divesting from one or more existing businesses, partially or totally.[1]

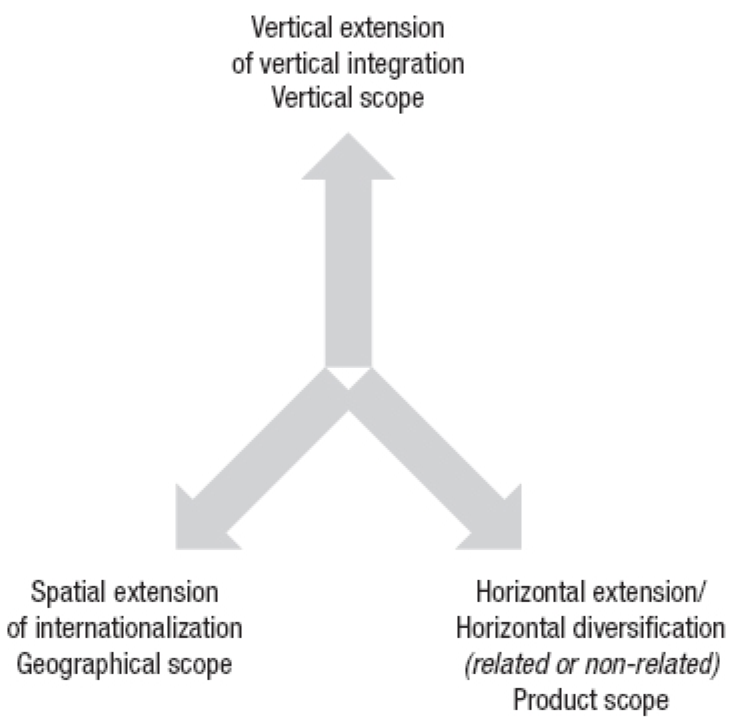
When Amplifon allocates its resources to increase market share in countries where it already competes, it is making a portfolio decision. When Campari diversifies and enters the wine business, it is implementing a portfolio decision. When General Motors agrees to sell its European automobile business under the Opel brand to the French rival group PSA, again, a portfolio decision is taken.

Portfolio decisions always translate into a change of scale, which can be primarily measured as the level of a firm's turnover or capital employed, or as the number of employees. Scale can also be quantified as production capacity understood as the maximum output manufactured or delivered by the firm in a given period by using the current resources.[2]

Portfolio decisions can also lead to a change in the corporate scope or the scope of the firm's activities ("scope"), which develops along three dimensions[3] (Figure 6.1):

- *Vertical scope* (or degree of vertical integration): the range of vertically linked activities that the firm chooses to carry out internally.
- *Product scope* (or degree of horizontal diversification): the range of industry segments or the range of industries in which the firm competes.[4]
- *Geographic scope* (or degree of internationalization): the geographic spread of activities or the range of geographies where the firm competes.

Figure 6.1 The dimensions of corporate scope



The Amplifon's strategy of committing resources to existing businesses defined as countries translates into a change in scale; while the entry into new countries reflects a change both in scale and in geographic scope. The entry into the wine business by Campari modifies its scale and the product scope. In the opposite direction, the General Motors divestiture in Europe entailed a reduction of scale and geographic scope.

Due to the relevance of growth within corporate strategy decisions, we will devote this chapter to an introductory discussion of this subject, while the next two chapters will be dedicated to growth strategies with a synergy approach (Chapter 7) and to growth strategies with a financial approach (Chapter 8). The topic of divestiture will be briefly outlined in section 6.5.

6.2 Decisions on growth

Investing in existing businesses and entering new businesses are defined as growth decisions or growth strategies whose contents encompass three elements:

- *Where to grow?* Answering this question means identifying the direction which the firm should take to modify its scale and scope.
- *Why to grow?* Answering this question means clarifying tthe motivations of growth, i.e. the strategic "rationale" and the factors of convenience underlying a specific decision.
- *How to grow?* Answering this question means choosing the mode of growth to bring a plan to life.

When a firm follows the synergy approach in corporate strategy, growth can develop in three "directions:"

- *Operational reinforcement*: the growth develops in an existing business.
- *Related expansion*: the growth aims at entry into a new business in an industry in which the firm already competes.
- *Related exploration:* the growth aims at entry into a new business in an industry in which the firm does not yet compete.

Amplifon's decision to increase the number of points of sale in a country is an operational reinforcement; General Motors' decision to invest for the first time in the business of electric vehicles would be a related expansion; while Campari's decision to invest in wine business can be described as related exploration, since it involves the entry into a new related industry.

The concept of relatedness deserves to be delved further into. Grant states that relatedness between businesses refers to:

1. The potential for sharing and transferring resources and capabilities between businesses at the operational level.
2. The ability to apply similar strategies, resource allocation procedures, and control systems across different businesses within the corporate portfolio.[5]

Relatedness is about resources and not products. It can also depend on the exploitation of strategic and operational commonalities through the role and functioning of the corporate headquarters.[6]

When a firm follows the financial approach in corporate strategy, there are two potential directions of growth to evaluate:

- *Financial reinforcement*, the growth affects an existing business.
- *Non-related exploration*, the growth aims at entry into a new and non-related business (i.e., a non-related diversification).

Consider the Exor group, which holds controlling interests in Fiat Chrysler Automobiles (automotive), CNH Industrial (earth moving machines), Partner RE (reinsurance activity), Ferrari (luxury sports cars), Juventus (professional soccer) and *The Economist* (publishing). A hypothetical decision by Exor to invest in the telecommunications would appear as a non-related exploration if no important operational synergies existed with the other businesses in the group's portfolio. On the other hand, an investment of resources to support a growth of one of the subsidiaries, such as Fiat Chrysler Automobiles, would be classified as financial reinforcement.

As concerns the rationale behind a growth strategy, it can depend on one or more of the following motivations:

- Benefiting from efficiency, growth, and market power advantages.
- Exploiting industry dynamics.
- Acquiring businesses undervalued by the market.
- Increasing the parent's ownership interest in a subsidiary.

The motivations for growth will be discussed in next two chapters. Although they are very similar between the synergy approach and the financial approach, a substantial difference exists in the priority the firm dedicates to each. In the synergy approach, the firm primarily seeks to leverage the various benefits arising from efficiency, growth, and market power advantages. For instance, the search for economies of scale drives the choice of operational reinforcement, while the desire to achieve operational synergies influences the choices of related expansion or exploration. Conversely, in the financial approach, the firm is much more interested in seizing the advantages of tighter control over subsidiaries through financial reinforcement, or the advantages of financial synergies when it carries out a non-related exploration.

The high growth of Amplifon and Campari was motivated by the fast expansion of the hearing aid retail market and by the consolidation of the spirits industry, as well as the ability of both companies to exploit operational synergies in marketing, distribution and procurement. On the other hand, the acquisition of one of the global leaders in reinsurance, the Partner Re group, was carried out by Exor group to reduce risk and to exploit the benefit of the internal capital market.

Moving on to the choice of modes of growth, they are divided into two basic paths: internal development and external development (mergers and acquisitions, non-equity alliance and equity alliances). Finding the right mode of growth depends on a strategic and cost-benefit analysis and a careful evaluation of its financial sustainability.[7] For instance, Amplifon's growth journey took place principally through internal development in the existing geographies and through acquisitions for entering new ones. Campari has been able to combine 50% turnover growth due to internal development and the remaining 50% from external development. The Angelini group, the leader in Italy in absorbent hygiene products with brands such as Lines and Pampers, and one of the main players in detergents for fabric and household cleaning with brands such as Ace, Neoblanc and Comet, met its growth ambitions by allying with the multinational Procter & Gamble to form a joint venture known as Fater.

6.3 Valuing growth decisions

To select the best strategy to growth, the different alternatives must be evaluated by considering their impact on profitability and value creation as well as their financial feasibility.[8]

The profitability analysis makes use of techniques for developing financial projections and for calculating accounting-based performance indicators concerning profitability, growth, liquidity, and solidity, in order to measure the impact of growth on accounting profit. Although accounting profit alone offers little guidance to make choices, it has to be properly estimated to understand the impact of this kind of strategy on future financial statements and ratios. It should not be forgotten that financial statements are broadly used to make longitudinal and interfirm comparisons by analysts and other stakeholders such financial institutions.

Building on financial projections, it is then possible to measure how the growth affects the creation of value. That analysis can take place using two models. On the one hand, within the temporal horizon in which the growth plan takes place, it is possible to measure the Economic Value Added (EVA) generated by the investment.[9] On the other hand, the value can be calculated as the Net Present Value (NPV) of the returns that such an investment generates.

Lastly, the evaluation should also include an analysis of the firm's capability to fund the growth investment over time either through self-financing or by collecting additional resources on capital or debt markets. The main sources of funding are retained earnings, proceeds from divestiture of non-core businesses, bank loans, debt issues, and equity funding.

Nothing can be left to chance in planning profitable growth. This includes the funding policy, that should leave some room for financial flexibility allowing to adapt the strategy during its implementation.

6.4 The dilemma of growth

A growth strategy is not easy to carry out on an organizational and financial level, and it can produce tensions within the leadership and organization during execution. Faced with a choice that is risky and has an uncertain outcome, a basic question often arises: is profitable growth an imperative or a choice?

Growth is always a choice resulting from a managerial discretion, unless certain circumstances do not emerge that make it an imperative:[10]

1. The firm holds a first mover advantage that it must rapidly consolidate to prevent other actors from entering the market and replicating its strategy.
2. The market in which the firm competes expands, with the effect of weakening the competitive position of those who do not keep the pace.
3. The firm does not have the “critical mass” to play in a certain competitive area.
4. The industry consolidation or globalization give advantages to those who reach a larger scale.
5. The industry where the firm has historically operated is in decline or transformation and it is necessary to identify investment opportunities elsewhere.
6. Customers or suppliers grow in size, exercising greater bargaining power to the detriment of the firm.
7. Some stakeholders threaten the sustainability of the whole firm or a certain business in which it invested (e.g. the government enacts new regulations not favorable to the firm).

Whether it is an imperative or a choice, various studies have analysed the behaviour of growth champions to discover their recurring traits or similarities and to sensitize other firms committed to grow. They can be summarised as follows:

- The value of growth plays a central role in the corporate culture.[11]
- Growth is a key commitment or ambition included in the firm’s vision statement.[12]
- Leadership is committed to changing the configuration of the business portfolio proactively.[13]
- The ownership clearly expresses expectations for growth that are correctly transmitted to the leadership through well-designed and managed governance bodies.
- In private firms, ownership is also willing to moderate its dividend expectations in the medium-term to favor the reinvestment of

resources in the growth plan.
- All management systems emphasize the importance of value creation (in budgeting, reporting, and appraising performance).[14]

A last point remains to be addressed: some leaders present growth as the best opportunity to protect the firm from hostile takeovers or to build "empires" able to influence market dynamics and firm's performance through greater market share or organizational power. These motivations should be carefully investigated and seen as unhealthy, as leaders risk becoming more concentrated on extracting benefits and perks for themselves – such as a high level of personal prestige or status, very generous compensation, and the possibility to exert power over broader organizations[15] – than on creating value.

6.5 Divestiture decisions

The partial or total divestiture from one or more businesses[16] reduces the scale and sometimes the scope of the firm. Three essential elements describe this sort of decision:

- *Where to divest?* Answering this question means identifying the business (or businesses) to be divested among those in the portfolio.
- *Why to divest?* Answering this question means explaining the strategic "rationale" or the motivations justifying the sale of a business.
- *How to divest?* Answering this question means choosing the mode of divestiture.

The choice of the business to be divested is linked to the rationale motivating this type of decision: *where* and *why* are connected each other. There are seven rationales to divest, which are not mutually exclusive:

1. *Unsuccessful portfolio strategy*. A business is a candidate for divestiture when it no longer contributes to producing synergies within the portfolio. This implies that the criterion of added value is no longer satisfied.

2. *Unsatisfactory financial performance*. As suggested by the business logic criteria, a business must be sold if the performance is structurally unsatisfactory. The same is true every time a business is not able to reach the "critical mass" to compete effectively, also in the future.
3. *Poor market performance for listed companies*. If market performance is penalized by a corporate discount,[17] a divestiture of one or more businesses criticized by the capital markets should be considered, to protect the interests of the shareholders. Such decisions can also be necessary to respond to the activism of institutional investors (known as shareholder activism),[18] who are well-known for their capacity to influence the firm's strategy by actively participating in shareholders' meetings and publicly expressing their valuation and judgment on the firm's performance.
4. *Stakeholder pressure*. Pressure can manifest itself in different ways. First of all,[19] some firms could prefer to sell a business to be more socially responsible or to respond to the sensitivities of the community in which they operate, or of their customers. Divestiture of some businesses could also be forced during mergers and acquisitions to respect the recommendations of market regulatory authorities or competition authorities to protect collective interests, or to avoid the creation of a dominant position on the market. Finally, the financial system can exercise pressure on firms under restructuring to push them to rapidly sell-off one or more businesses in order to swiftly rebalance their debt situation.
5. *Appointment of new leadership*. A change in leadership usually entails a review of the company's vision. Businesses that in the past were treated as core could be reclassified as non-core, becoming good candidates for divestiture as soon as the market conditions are convenient.[20]
6. *Opportunity to sell a business with the capital market logic*. When the market overvalues and overprices a business, a firm can take advantage of the situation to create value by selling it for more than it is worth. Since beating the market is not easy, this kind of choice should be carefully investigated to be sure that market price of the business is actually higher than its fair value.
7. *Need to rebalance the financial position*. The partial or total sale of a business can be based on the need to rebalance the firm's financial

position, independent of outside pressure. Leadership can simply want to reduce the degree of financial risk the firm bears.

Two examples can help clarify the rationales for corporate divestiture. First of all, in 2017 General Motors decided to sell off the Opel business after CEO Mary Teresa Barra developed a new vision for the American automotive giant. Secondly, in 2015 the Anheuser-Busch InBev group reached an agreement to acquire its rival SABMiller, becoming the first global player in the beer industry with a market share of over 30 percent. However, American anti-trust authorities made their approval conditional upon the commitment to sell the U.S. beer producer MillerCoors, previously owned by SABMiller, to avoid creating a dominant position on the market.

Coming to the modes of divestiture, they can be summarized as follows:[21]

- *Sell-off*, the transfer of the ownership of a business to a third party for a price. When the counterparty principally uses the debt market to finance the sell-off and the unexploited debt capacity of the firm to be purchased, it is said that the sale of the business takes place through a leveraged buyout (LBO).
- *Spin-off*, the distribution of shares of the divested business to shareholders of the parent firm.
- *Equity carve out*, the parent company sells a portion of shares of a business in its portfolio to the general public and keeps the rest.
- *Split-up*, shares are first created in the businesses forming the portfolio, while the shares in the parent company are then discontinued.

The case of Fiat Chrysler Automobiles group showcases the importance of divestitures. In 2003, the group sold the Toro insurance business to the De Agostini group through a sell-off operation. In 2010, a spin-off was carried out that led to the separation of Iveco, CNH, and a part of Fiat Powertrain from the rest of the group, in which only the activities related to the automotive sector were kept (under the brands Fiat, Lancia, Alfa Romeo, Maserati, Ferrari, Magneti Marelli, Teksid, Comau, and the part of Powertrain producing automobile engines). In October 2015, an equity carve out allowed to list 20 percent of the shares of the subsidiary Ferrari on the New York Stock Exchange. Lastly, at the start of 2016, a new spin-off operation was carried out through the distribution to the group's shareholders of 80 percent of the shares in the subsidiary Ferrari. Also thanks to corporate divestitures, the total return for shareholders of FCA has been positive and among the highest in the sector in the recent decades.

A final point must be made: the scope can also be reduced through outsourcing, not only corporate divestitures. However, outsourcing does not have the aim of removing a business from the portfolio, but rather of externalizing one or more activities in the value chain of a business. There can be multiple reasons: convenience, improving the quality or the level of service of the outsourced value chain activity (compared to the case of internal execution), or reducing the internal transaction costs with respect to the alternative of buying on the market. Outsourcing decisions must not be confused with the exit from a business. They are choices to be placed in the competitive domain, not the corporate one.

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[1] For the definition of portfolio strategy, see Chapter 1.

[2] Production capacity is not widely adopted by multibusiness firms to measure scale because its adoption would make it necessary to take into account the mix of outputs produced by the single businesses belonging to the portfolio. This exercise is theoretically feasible, but practically less relevant.

[3] Airoldi, Brunetti and Coda (2005); Collis et al. (2012); Grant (2015).

[4] Some scholars, such as Collis et al. (2012), measure horizontal diversification through the number of product-market combinations in which the firm competes.

[5] Grant (2015), p. 355.

[6] For a further discussion of the role and functioning of corporate headquarters, see Chapter 14.

[7] See Chapter 9.

[8] Zara (2005).

[9] Economic Value Added can be measured as net operating profit after tax (NOPAT) less cost of capital, where cost of capital is calculated as capital employed multiplied by the weighted average cost of capital (WACC).

[10] Chan Kim and Maurbogne (2015); Collins (2011); Laurie, Doz and Shee (2006); Maurbogne and Chan Kim (2017); Mazzola (2002).

[11] Coda (1988).

[12] Collins and Porras (1996); Collis et al. (2012); Norman (1977).

[13] On the characteristics of leadership styles, see Chapter 16.

[14] Copeland, Koller and Murrin (2000).

[15] Jensen (1986), Zattoni (2006).

[16] Brauer and Schimmer (2010); Denning (1988); Dranikoff, Koller and Schneider (2002); Elfenbein and Knott (2014); Montgomery and Thomas (1988); and Puranam and Vanneste (2016).

[17] For a definition and further discussion of the corporate discount, see Chapter 8.

[18] On the issue of shareholder activism, see Chapter 13.

[19] On the issue of corporate social responsibility, see Chapter 3.

[20] For further discussion of the subject of core and non-core businesses, see Chapter 5.

[21] Puranam and Vanneste (2016).

7 Growth with a Synergy Approach

by *Paolo Morosetti*

7.1 The directions of growth

How can firms with a synergy approach to corporate strategy achieve profitable growth?

Consider the story of Ferrovie dello Stato Italiane Group (FS Italiane Group). The group was founded in 1905 in Italy to support the unification of local railway systems under a national standard and to create a market player able to meet the changing needs of the railway industry by investing in the technological development of the network and in the innovation of an offering consisting of passenger transport services.

In the decades after its founding, the group concentrated primarily on the launch of new services in Italy, such as regional transport and long-haul transport. Afterwards, it entered freight and local public transport businesses with the effect of becoming a full-fledged multibusiness firm.

At the beginning the geographic footprint was still limited to Italy and continued to be for a long time because the industry was extremely regulated internationally with state-owned national champions controlling the domestic markets where they operated.

The year 2011 marked a turning point in the group's corporate strategy, as it declared its intention to transform itself into a European mobility player. This was possible because the European and national regulations were softened while some local players were privatized. It all started with the acquisition of Arriva Deutschland, the third-largest passenger transport service provider in Germany, now known as Netinera. This was followed by the launch of other initiatives in Great Britain, France and the

Netherlands. In 2016, another key step in this direction was the acquisition of Trainose, Greece's leading railway operator.

Turning to the most recent developments, another significant change of pace was marked by the acquisition in 2017 of Anas, a large state-owned company managing more than 30,000 km of roads and highways in Italy. The move allowed the FS Italiane Group to qualify as an integrated mobility operator, with the leading integrated network of railways and roads in Europe in terms of inhabitants served.

Has this growth strategy been able to create value over time? If we focus on the most recent years, we see that the FS Italiane Group recorded revenues of 12.1 billion euros in 2018, which were more than 2.9 billion euros higher than in 2017, mainly due the acquisition of Anas. Gross operating profit increased to about 2.5 billion euros and the profit for the year reached 559 million euros. Growth has been happily combined with the goal of creating value in the short term, and there are great expectations for the years to come.

The story of the FS Italiane Group is neither unique nor isolated. There are plenty of firms able to grow as well as many others that have failed miserably. Building on empirical evidence and literature in this field, we came to the conclusion that firms opting for a synergy approach in corporate strategy can pursue growth by following three main directions, that can even be mixed together: *operational reinforcement*, *related expansion*, and *related exploration*. In the next sections, we will explore each one of them. Then we will reflect on the motivations for growth and the main traps to be avoided to succeed.

7.1.1 Operational reinforcement

An operational reinforcement strategy aims at sustaining the growth of existing businesses. When successfully undertaken, it increases the scale of the business and creates value by improving its competitive advantage over rivals. Conceptually, this strategy can be realized through:

- Reinforcement adjacencies.
- Inside-out options.
- Strengthening owner's control.

Reinforcement adjacencies modify the competitive scope[1] of a business, which is commonly described by combining three dimensions: (1) the segment scope, the variety of the products or services provided and the customers served; (2) the geographic scope, the extension of the geography served; and (3) the vertical scope, the extent to which the activities are carried out in-house.

We find that these dimensions can be better analysed if they are reorganised into four categories representing specific options for growth in an existing business:

- *Product adjacency*: the launch of new goods or services to satisfy the customer segments served.
- *Customer adjacency*: the entry into new customer segments.
- *Channel adjacency*: the use of new distribution channels to reach the customers segments served.
- *Coverage adjacency*: the increase of the number of locations to saturate the geographic market where the business competes (Table 7.1).

Table 7.1 Operational reinforcement: examples

Type of adjacency	Examples
Product adjacency	The expansion of the range of services offered to customers in the business of fixed broadband communications by a company such as BT.
Customer adjacency	The decision to sell rubber seals to white appliance manufacturers by a player specialized in serving the producers of boilers for heating.
Channel adjacency	The initial introduction of the online channel for marketing men's shoes by a firm such as Tod's.
Coverage adjacency	The opening of new branches in Italy by the commercial bank Che Banca!

The implementation of a reinforcement adjacency does not require devising a new competitive strategy, given that everything takes place within an existing business. In addition, make or buy decisions impacting the vertical scope of a business are not treated as a reinforcement adjacency. Of course, they remain relevant to formulate the competitive strategy associated with a business.

As regards inside-out options, these aim at increasing the scale of the business without modifying its competitive scope. The variety of options that can be undertaken is very broad, and in part, is a function of the business considered. For example, a firm can follow a penetration pricing policy to gain market share or it can hire more sales personnel.

Finally, the option of strengthening owner's control describes the increase in the parent's ownership interest in a subsidiary where control is retained. This happens by (1) purchasing additional outstanding shares of the subsidiary, (2) causing the subsidiary to repurchase a portion of its outstanding shares (a treasury stock buy-back) or (3) causing the subsidiary to issue additional shares to the parent company. Of course, those transactions can be carried out only when the firm is organized in the legal form of a group. For a firm adopting a divisional structure (or similar), that option has no reason to exist.

7.1.2 Related expansion

A related expansion strategy leads the firm to enter a new business in an industry in which it already competes. This means that the number of businesses in the portfolio increases and the corporate scope expands along the product and geographic dimensions. If we use the jargon of adjacencies, a related expansion can be pursued through:

- *Segment adjacency:* entry into a new segment in an industry in which the firm already competes. This option reflects a horizontal diversification, which leads the company slightly away from the existing businesses.
- *Geographic adjacency:* entry into a new geography in an industry in which the firm already competes, which will be managed as a separate business from a strategic perspective (Table 7.2).

Table 7.2 Related expansion: examples

Growth options	Examples
Segment adjacency	The entry into the business of motorcycle and commercial vehicle braking systems by the Brembo group.
Geographic adjacency	The series of entries into the new countries of Europe, the Americas, and the Indo-Asian area by the Vodafone group to internationalize a group that was previously rooted mainly in the UK.

The geographic adjacency assumes that the firm internationalizes through any entry mode, such as direct investment or exporting,[2] and recognizes the importance of developing a competitive strategy to succeed in the new geography by addressing the unique combination of local characteristics or idiosyncrasies.

7.1.3 Related exploration

A related exploration strategy extends the corporate scope and adds a new business to the portfolio through entry into a new and related industry. In this case, there are essentially two growth options:

- *Industry adjacency*: entry into a new industry through horizontal related diversification.
- *Vertical adjacency*: expand along the industry's value chain through vertical integration (Table 7.3).

Table 7.3 Related exploration: examples

Growth options	Examples
Industry adjacency	The entry into the confectionary business by a firm specialized in manufacturing chocolate such as Ferrero.
Vertical adjacency	The entry into beverage wholesaling by a beer producer such as Carlsberg.

Vertical integration can be partial or full.[3] Through a partial integration the firm takes over ownership and control of vertically integrated activities along the industry's value chain, but it continues to partially use the market either to acquire some inputs or components upstream or to reach the end customers downstream. This implies that it does not produce all of its own inputs autonomously, nor does it sell its goods and services only through its own channels or sales personnel. For instance, an olive oil producer is partially vertically integrated if it produces oil not only with the olives it grows, or if it sells oil through both its own shops and through other independent distribution channels. Firms that have undertaken a partial vertical integration usually manage the different stages along the industry's value chain as conceptually separate businesses, that sometimes can also sell their goods and services to third-parties. Each business, therefore, pursues its own competitive strategy.

Through full integration, on the contrary, the firm internalizes vertical integrated activities within a value chain linked to one of its own businesses. This choice lies between the make or buy decisions and does not create the need to run the vertically integrated activities as a new and separate business in the portfolio. A full vertical integration regards the field of competitive strategy, not that of corporate strategy.

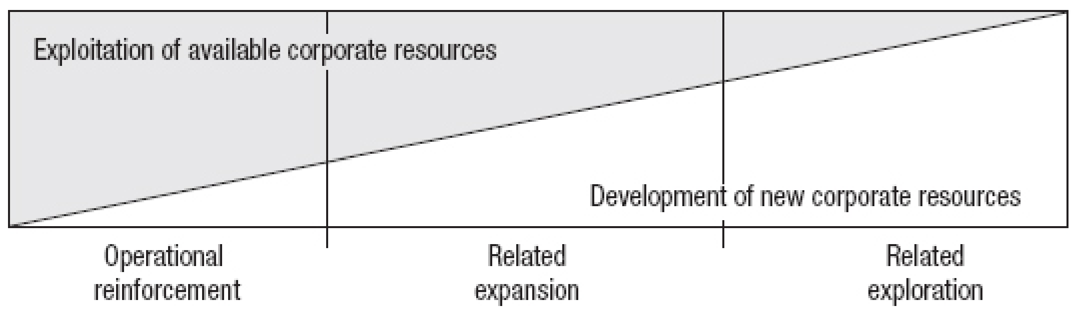
7.1.4 The discipline of growth

The implementation of growth options allows firms to make bets and investments in a number of future business opportunities, but how should they be prioritized, above all if resources are limited?

Corporate finance theory suggests selecting alternatives on the basis of their capacity to create value. This judgment is extremely important, but there is another aspect to consider carefully at the same time. By moving from reinforcement to exploration, the degree of uncertainty and strategic and organizational complexity tends to increase, posing specific managerial challenges for each direction of growth.

In principle, we recommend giving priority first to operational reinforcement, then related expansion and related exploration, in that order. In this way, the firm can match its value creation objectives with the need to minimize strategic and organizational risks or to gradually bear them to let the organization learn to adapt over time[4] (Figure 7.1).

Figure 7.1 Growth with a synergy approach and the resource-based view



In more detail, operational reinforcement is easier to conceive of and implement since leadership moves in a competitive area it should be deeply familiar with and in which it can mainly exploit resources already present in the organization.

When related expansion is undertaken, on the other hand, the complexity to be faced increases substantially, because there is a greater need for the organization to adapt to a new environment and to cope with more uncertainty. For example, the firm may be only partially familiar with industry's critical success factors or the corporate headquarters may not be well equipped to manage new kind of corporate resources.

Lastly, a related exploration strategy is usually an even more ambitious choice to be made since the firm must have the greatest ability to learn to adapt. On the one hand, new competitive dynamics should be explored. On the other hand, substantial new knowledge should be created, retained and transferred within the organization.

The proposed discipline of growth has three main exceptions. First, strategy is not only intended as a plan to deal with situations, but also the outcome of emerging patterns consistent with the direction chosen by the leadership. Therefore, if along the path for growth an opportunity emerges unexpectedly, like the possibility to acquire businesses in an expansive or even explorative logic, the leadership should not be afraid to evaluate it and then make the best use of it.

Second, if the leadership sets the goal of transforming the business mix to impose a new vision on the firm, the logical order between reinforcement, expansion, and exploration can be easily subverted. This type of transformation usually requires courageous diversification decisions often coupled with divestiture from historical businesses to be realized.

Third, there are firms able to manage reinforcement, expansion and exploration by leveraging an ambidexterity approach to management, defined as "the ability to simultaneously pursue both incremental and discontinuous innovation ... from hosting multiple contradictory structures, processes, and cultures within the same firm."[5]

The growth strategy of P&G exemplifies this ability. As stated in the 2012 Annual Report, the world's largest consumer packaged company is eager to underline that its strategy is persistently based both on strengthening core business and renewing the focus on discontinuous innovation.

7.2 The motivations for growth

Why do firms with a synergy approach to corporate strategy want to grow? The are many reasons that help explain the motivations for growth, which can be grouped as follows:

1. Benefiting from efficiency, growth, and market power advantages.
2. Exploiting industry dynamics.
3. Acquiring businesses undervalued by the market.
4. Increasing the parent's ownership interest in a subsidiary.

7.2.1 Benefitting from efficiency, growth, and market power advantages

Growth is profitable when one or more of the following three advantages are captured:

- Efficiency advantages.
- Revenue or growth advantages.
- Market power advantages.

Efficiency advantages generate costs savings by eliminating redundancies or improving the productivity of business processes, or reductions of the capital employed by optimizing such things as working capital and fixed assets.

The main economic mechanisms underlying the gain in efficiency are economies of scale, economies of scope, and economies in transaction costs.

Economies of scope are cost economies from producing increasing output across multiple businesses and are the main source of synergies[6] together with economies in transaction costs, which are relevant to analyze vertical integration and are understood as cost economies generated by internalizing transactions that a firm can govern more effectively internally than through markets or contracts.

Economies of scale are cost economies resulting from increasing the scale of a specific value chain activity or a function. They are the key reasons of operational reinforcement. Some scholars include them in the sources of synergies while others have diametrically opposed positions because economies of scale relate to a single product or a single value chain activity, not to two or more businesses. We prefer to include this category also in the sources of synergies to be consistent with the analysis on operational synergies described in Chapter 5.

Efficiency can also be obtained by exploiting the replication effect and a localization advantage.

A replication strategy is based on a simple principle: the possibility of large-scale replication of a business model. This implies that a stage of investment in which the business model is designed and operationalized, is followed by a stage of exploitation in which it is replicated over time at very limited marginal costs. This strategy is broadly adopted by chain organizations such as food and fashion retailers to pursue coverage or geographic adjacencies. The value creation largely depends on the possibility of transferring knowledge during replication, the existence of a central organization coordinating the entire process and committed to replication, and a template or a business model that will potentially be replicated.[7]

As for the localization advantage, it consists of benefits achievable by localizing some value chain activities in one geography rather than others because they enjoy comparative advantages.[8] In other words, geographies hold location-specific market features or factors of production that let the firm improve its competitive or corporate advantage.[9] The benefits related to the location advantage span from lower labor costs, to superior infrastructure, access to skilled labor, and an abundance of technological factors such as research facilities.

With regard to growth advantages, they can be seized when the firm is able to increase the consumer utility. This typically occurs by bundling different resources together, such as products or services, to generate new solutions for consumers, and by promoting cross-selling and one-stop shopping policies. Spotting these opportunities requires an in-depth understanding of consumer behavior and markets dynamics, in contrast to efficiency advantages that derive more from an internal analysis of the value chain.

Finally, a market power advantage can be exploited when the growth strategy mitigates the intensity of competition, prevents the erosion of market prices or allows the firm to lead an industry shakeout to become an oligopolist and to derive a maximum advantage from that position.[10] Of course, these strategies are not always feasible because they can lead to anti-competitive behavior that anti-trust laws and authorities frequently restrict.

In particular, a market power advantage can be realized through:[11]

- Predatory pricing.
- Product proliferation.
- Bundling.
- Defensive vertical integration.
- Mutual forbearance.

Predatory pricing aims at driving out specialized players from a market by using the firm's profit to allow one of the businesses in portfolio to sell below the market price. The sacrifice of short-term profits will be compensated by the recovery of lost profits in the medium-term by increasing sales prices again. Note that firms do not necessarily have to engage in predatory pricing. It is enough to send signals of threats to new competitors to obtain the result of preventing their activism.

Through a product proliferation policy, a firm deliberately chooses to saturate the market in which it operates with an excessive number of product variants, some of which may not even produce positive financial results. This policy slows down or prevents an attack by competitors or new entrants that will find it difficult to identify viable business opportunities to enter the market (this situation is also known as the “crowding out” effect).

By bundling two products together, a multibusiness firm can leverage the strong market power that it has in one business, to sustain the development of a related business.

Another way to extract benefits from market power is defensive vertical integration. This happens whenever the firm integrates along the industry’s value chain to block access by third parties to strategic production factors or to more important distribution channels to reach the end client.

Lastly, mutual forbearance occurs when the firm competes in multiple markets interconnected each other in a multi-competition game: “situations in which firms compete simultaneously against the same rivals in more than one market.”[12] In this context, the firm might “cede the control of some markets” to a rival in exchange for that rival’s acquiescence in others. In markets where the firm plays as follower, therefore, it will have no incentive to attack rivals in a leadership position and trigger a price war, because rivals might react in markets where they hold a position of follower while the firm is the leader. Recognizing the possibility of mutual harm and cross-retaliation, rivals act to cooperate and perpetuate a balance of power that is in everyone’s interest, with the effect of keeping prices high and preventing the entry of new players. Empirical evidence shows that strategies of mutual forbearance have a positive effect on an industry’s profitability, and are most likely to be pursued by firms competing in multiple geographic markets.

7.2.2 Exploiting industry dynamics

A growth strategy can be formulated to prevent or react to the evolution of an industry's life cycle.

The market development phase attracts the interest of firms that want to bring new goods or services to market first in order to gain a first mover advantage. Think of what has happened in the electric automobile market and the ecosystem associated with it: in the last decade numerous firms coming from the automotive, infrastructure, information technology, and energy sectors have invested significant resources there in the hope of reaping attractive economic returns in the future.

Industries in the growth phase capture the attention of firms because demand begins to accelerate and the size of the total market expands rapidly.

In industries in the maturity stage, a growth strategy can be directed to gain additional market share or to escape from a state of gradual but steady revenue per capita decline.

In industries in the phase of decline, characterized by demand contraction and overcapacity, firms can choose between two alternatives. First, they can still gain market power tactically through mergers and buy-outs to concentrate supply in fewer hands, with the goal of hastening their competitors' decline or exit from market. Second, they can accelerate the transformation of their business portfolio through related explorations. No firm wants to remain trapped in a competitive space that is not attractive or that will be less and less attractive in the coming years.

Finally, some industries can go through a reorganization of market boundaries triggered by technological innovation, evolutions in social behavior that affect consumption, globalization, and regulatory changes.[13] In this situation, growth can be necessary to take advantage of these transformations, or again, to escape towards other related sectors. For example, the convergence between telecommunications, publishing, and media has redrawn the boundaries and interactions of these industries with the effect of pushing different players to embark on new corporate strategies to compete in multiple markets.

7.2.3 Acquiring businesses undervalued by the market

Some growth strategies can also hide a financial motivation: the firm has the possibility to acquire an undervalued company whose price is lower than its fair value. There are multiple factors explaining why the market misprices a company or a business, such as fewer buyers relative to the number of sellers, differences in the information available to different buyers, or the way the deal is structured. These motivations fall in the domain of the capital markets logic.

It is worth noting that this logic cannot be the only one motivating the growth strategy if the firm has decided to pursue a synergy approach to corporate strategy. Capital market logics supplements the business and added value logic in this field.

7.2.4 Increasing the parent's ownership interest in a subsidiary

A reinforcement strategy can aim at increasing the parent's ownership interest in a subsidiary where control is retained, to influence its strategy and main business policies so as to obtain benefits for the whole group. The decisions most affected by the parent's power are the following:

- The definition of the strategic direction.
- The approval of the business plan.
- The ability to approve capital expenditures, raise funding, and wind up the entity.
- The distribution and reinvestment policy.
- The key organizational choices.

The "power to control" is exercised through the appointment of a representation of the parent company in the governance of the subsidiary. The stronger the parent's ownership interest in the subsidiary, the stronger the parent's influence on the appointment of leadership and on decision-making processes in the subsidiary.

For example, in early 2017, The Walt Disney Company announced its intention to increase its interest in Euro Disney – from 76.7% to 85.7% - and to make a cash tender offer for all remaining outstanding shares. At that time, Euro Disney S.C.A. was the holding company controlling Disneyland Paris, which included the Disneyland Park, the Walt Disney

Studios Park, and seven themed hotels with approximately 5,800 rooms, two convention centers, the Disney Village, a dining, shopping and entertainment center, and golf courses. Euro Disney's shares were listed and traded on Euronext Paris. Through the increase of the parent's ownership interests, The Walt Disney Company wanted to exercise full power over the underperforming subsidiary and bring the European business in-house to restructure it.

An increase of the parent's ownership interest in a subsidiary is sometimes an intermediate step before divestiture. By cashing out minorities, the parent becomes more independent in choosing and negotiating the best divestiture option.

7.3 Growth traps to avoid

The analysis of motivations for growth inevitably leads to emphasizing the benefits of an increase of scale or an extension of the corporate scope. However, anecdotal cases and empirical evidence show that those strategies can also translate into failures, to a greater or lesser extent, and into a destruction, rather than creation, of value. While there are multiple reasons for failure, there are five recurring growth traps to monitor:

- Diseconomies of scale.
- Loss of flexibility.
- Overestimation of synergies or negative synergies.[14]
- Limited adaptation to differences across countries.
- Limits of vertical integration.

7.3.1 Diseconomies of scale

Big is better is a journalistic-type statement rather than one based on facts. Indeed, the theory of economies of scale stresses that a limit exists beyond which further growth risks producing diseconomies rather than economic advantages.

There are two primary causes of diseconomies of scale. On the one hand, many value chain activities suffer from decreasing returns to scale due to the existence of technical constraints that hinder the use of a production factor in a more efficient way with the increase of scale. On the other, larger firms can suffer from organizational or managerial diseconomies:[15]

1. Inefficiencies due to the greater need for control and coordination. First, it's impossible to expand the scale without adding hierarchical layers, at the risk of some redundancy. Second, high-level executives in complex organizations suffer from bounded rationality because they are no longer able to make decisions based on facts, since the information they use is likely to be distorted by bureaucracy, which mediates the connection between decision makers and markets.
2. Reduced accountability of leadership to stakeholders. The former risks to emphasize size over profitability, with the effect of tolerating organizational slack and resources misallocation.
3. Lower commitment of employees towards work, who can suffer from a sort of alienation. In a large-scale organization it is more difficult to understand the purpose of corporate activities as well as the contribution each employee makes to the whole.

7.3.2 Loss of flexibility

In capital-intensive businesses, the growth of the scale translates into cost structures in which the incidence of fixed costs becomes predominant in relation to the total, with the effect of increasing the break-even point and reducing the strategic and organizational flexibility to face changes in environmental conditions.

Those cost structures become particularly problematic in cyclical industries or when the transition from maturity to decline takes place faster than expected. In the short-term, the firm with the larger scale will suffer from a significant drop in profits due to volume contractions because the cost structure is strongly influenced by the fixed costs component. In the medium or long-term, it may not be sufficiently flexible (and reactive) to deal with the processes of downsizing of production capacity or to carry out an in-depth reorganization or realignment to reflect the external conditions, because the scale serves as an element of rigidity or an obstacle to action for renewal.

7.3.3 Overestimating synergies, or negative synergies

On many occasions, firms overestimate the benefits expected from the synergies, underestimate the costs for realizing them, or make managerial mistakes when converting a plan into results.

As regards the overestimation of the expected benefits, this can depend on the fact that there are firms that motivate an initiative for growth with the search for synergies that are not based on corporate valuable resources or that are based on overly optimistic assumptions.[16] In practice, synergies do not strengthen the competitive advantage of any of the businesses involved, with the final result of having no influence or a negative one on the corporate advantage. The overestimation of the expected benefits can also be linked to another circumstance: the firm does not realize that the value produced by a synergy will be exhausted within a specific time period, rather than being an advantage that persists. That situation typically arises when the synergy is determined by the transfer of an organizational competence between two or more businesses. After a phase of learning, the unit with a competence deficit will have filled the gap by making the synergy useless or less relevant.

As for the costs for realizing synergies, the items traditionally underestimated are the following:

- *Cost of coordination*, which involves costs in term of time, personnel and sometimes money, due to the need to coordinate the multiple business units. These costs depend on the complexity of the synergies to be realized.
- *Cost of compromise*, which arises every time the synergy to be realized requires performing some value chain activities in a non-optimal way for either of the businesses involved.
- *Cost of inflexibility*, which emerges when the implementation of a synergy creates a potential difficulty either in responding to a competitive attack or in divesting from a business that is no longer strategic. In the first case, the synergy prevents reactions in a business

due to the risk of undermining the position of the firm in the other businesses involved. In the second case, the synergy slows the exit from a business where the firm does not have a competitive advantage to avoid harming the other businesses benefiting from that synergy.
- *Cost of control*, which depends on the implementation of complex performance management and control systems to identify which units truly derive economic benefits from the synergy, how to correctly allocate the costs linked to their realization, and how to penalize the units that act improperly or cause disadvantages to other businesses in the portfolio.[17]

Finally, the benefit of synergies can produce disappointing results due to managerial mistakes in the execution phase, as often happens during the post-integration phase of an M&A deal.[18]

7.3.4 Limited adaptation to differences across countries

When in Rome, do as the Romans do. This adage is fundamental to understand a specific kind of growth trap related to geographic adjacencies:[19] the underestimation of distances or differences across countries and the lack of strategic adaptation to cope with them.[20]

Distances can be understood as entry barriers to a country that entrants coming from abroad must face, unlike players who already operate there. They can be codified as:

- Cultural distances.
- Administrative distances.
- Geographic distances.
- Economic distances.[21]

Adopting a focus on distances pushes a firm to recognize and invest in adaptation or variation when it crosses boundaries among countries. This adaptation deals with tailoring products or services to local requirements, redesigning business models to meet country-specific needs, modifying corporate policies to respond to cultural or administrative differences (such as in the human resources domain), and verifying the consistency of the business positioning in a specific area.

Although adaptation can become a business opportunity, it is essential to recognize that it always comes at a cost in terms of diminished economies of scale and increased complexity to manage. If the balance between advantages and costs is not properly investigated (and managed), the risk of jeopardizing the success of an international expansion increases, turning a potential success into a miserable failure.

7.3.5 Limits of vertical integration

A vertical adjacency conceals specific limits that should be carefully weighted before embarking on initiatives of this kind.

First of all, a firm that integrates vertically through mergers and acquisitions can trigger negative competitive reactions from its competitors, clients, or suppliers, based on the direction which integration takes. In the case of downstream integration, the suppliers of the business acquired could interrupt the supplies or make them less convenient or accessible since they would find themselves having to serve not a simple client, but also a competitor of theirs. To the contrary, in the case of upstream integration, the clients of the acquired business could revolt, since they would have to purchase goods from a subject who in the meantime would become their competitor.

In the case of The Walt Disney Company, the purchase of the ABC television network negatively influenced the quality of the commercial relationship of Walt Disney Studios with the television networks that competed with ABC at the beginning. At the same time, the production houses that compete with Disney, such as DreamWorks, became more reluctant to work with ABC as they feared their programming would be penalized.

Secondly, a firm integrating vertically could experience inefficiencies that penalize overall performance due to the poor capacity to plan and govern the organizational mechanisms to manage the coordination and cooperation between the sum of businesses positioned along the same industry's chain.

Thirdly, vertical integration often hides a prospective financial commitment, which not all firms are able to recognize properly and then sustain. This happens when the firm vertically integrates in a new business that might also have a competitive advantage today, but it underestimates the volume of investments required to stay competitive in the future.

The last limit of vertical integration is the increase of business risk due to higher dependence on the evolution of a single industry's value chain. If the sales in the end market contract, the vertically integrated firm will suffer more than diversified firms. Once again, embarking on a vertical integration strategy demands to reflect carefully on the financial strength of the firm and its ability to absorb the effects of demand fluctuations or a greater-than-expected contraction.

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[1] In literature, the notion of scope refers to the *corporate* scope (see section 6.1) or to the *competitive* scope. The former concerns the entire firms, the latter only a business.

[2] For further discussion of the entry modes, see Chapter 12.

[3] Grant (2015).

[4] Zook and Allen (2001).

[5] Tushman and O'Reilly (1996).

[6] For further discussion of the issue of synergies, see Chapter 4.

[7] Winter and Szulanski (2001).

[8] A country has a comparative advantage when the cost-opportunity in production of a certain good is lower in that country than in others.

[9] Porter (1990).

[10] For a discussion of the formation of prices and the quantities of equilibrium in an oligopoly, see Besanko et al. (2013).

[11] Hay (1976); Salop (1978); Yu and Cannella (2013); Golden and Ma (2003); Knoll (2008).

[12] Karnani and Wernerfelt (1985).

[13] Bartlett and Ghoshal (1989); Day and Reibstein (1997); Kim and Mauborgne (2005).

[14] For a discussion of the issue of negative synergies, see Chapter 4.

[15] Williamson and Bhargava (1972), Williamson (1975).

[16] An emblematic case of overestimation of expected benefits due to erroneous strategic assumptions is represented by the brand dilution cited in section 4.4.

[17] The sum of costs to achieve synergies constitutes one of the causes that explain the "lack of responsiveness" of firms that diversify.

[18] For a discussion of the subject of obstacles to strategic-organizational change, see Chapter 17.

[19] If exporting is included in the coverage adjacencies, this trap is relevant for operational reinforcement as well.

[20] For a discussion of the relationship between internationalization and performance, see Glaum and Oesterle (2007); Hitt, Hoskisson and Kim (1997); Hsu and Boggs (2003); Riahi-Belkaoui (1998); Ruigrok and Wagner (2003).

[21] Ghemawat (2001; 2007).

8 Growth with a Financial Approach

by *Guido Corbetta*

8.1 Growth: from a synergy to a financial approach

Firms can expand and create value for decades without ever making a growth decision with a financial approach, which consists of unrelated diversification.

The Zegna group has a storied history that stretches back more than a century. Born in 1910 in Trivero (close to Biella in the North of Italy) as a manufacturer of fabrics for men's suits, it quickly expanded abroad through export with a strategy yielding such good results that by 1945, Zegna fabrics were sold in over 40 countries, including America. In the 1960s, the group began the production of men's formalwear and completed a back integration in the supply chain to control the quality in every stage of operations, from raw material selection to manufacturing. In the 1970s, the increase of international activity continued through the establishment of new commercial branches and also factories outside of Italy, such as in Spain and Switzerland (and then in Turkey and Mexico in the 1990s). In the 1980s, a strategy of forward integration was launched to develop the retailing business on a global scale. Today, there are more than 555 Ermenegildo Zegna points of sale in over 80 countries. At the end of the 1990s, a comprehensive strategy of related diversification brought the group into new businesses such as casual wear and sportswear, accessories, footwear, and leather goods for men. At the same time, an investment in the women's wear and accessories sector was carried out by acquiring Agnona, a specialized woolen mill.

The Zegna group's pathway to growth mirrors the basic principles of the synergy approach. On the one hand, the directions of growth gradually undertaken range from operational reinforcements, such as in the textile business, to related expansions and explorations, such as in the internationalization of men's wear, the entry into the casual wear segment, and the development of retailing. On the other hand, the chief motivations for growth were the opportunity to benefit from efficiency and growth advantages together with the exploitation of various industry dynamics.[1] For example, the competences in collection management developed in men's clothing were transferred to women's clothing operating under the Agnona brand, while the group was one of the first luxury brands to invest in emerging markets such as Brazil, Russia, India and Russia.

Contrary to the Zegna group, there are firms pursuing a different path as it comes to diversification, such as Exor, Edizione and De Agostini.

The history of Exor can be traced back to the end of the 19th century, when the Agnelli family who controlled Fiat, one of the national champions in the automotive industry in Europe, decided to establish an investment company through which to implement an unrelated diversification strategy. Today, the result of this history spanning more than a century has the name of Exor, a publicly-listed holding company whose portfolio of shareholdings ranges from automotive (Fiat Chrysler Automobiles and Ferrari) to publishing and media (The Economist), and agriculture and construction equipment (CNH International).

Instead, the development of Edizione is intertwined with the history of the Benetton family. After fast, international growth in casual clothing and fashion retail with the Benetton brand, in 1981 the four Benetton siblings decided to establish Edizione as a family holding company with the mission to control their ownership interests in The Benetton Group and to drive and govern the process of unrelated explorations. The investment philosophy was to combine the family's entrepreneurial approach to business with rigorous financial discipline. Over the years, this philosophy has turned Edizione into an institutional investor, who optimizes returns in the long term for a targeted level of risk and plays an active role in the governance of companies where it invests. Today, the business portfolio stretches over many industries: fashion, textile and clothing, food and beverage retail distribution, real estate, agriculture, and infrastructure. The holding carried out also some relatively minor investments in banking and insurance.

Lastly, the De Agostini group followed a similar strategy. In the 1990s, it invested a significant part of a capital gain realized with a financial transaction (the sale of Seat Pagine Gialle to the Telecom group) to enter the industries of gaming, insurance and private equity These businesses were all very dissimilar from publishing, where the group had been active for the first ninety years of its history and in which still competes.

The three cited case studies outline stories not comparable to that of Zegna.[2] Unrelated diversification was the fuel of their corporate development: it created value mainly by exploiting financial synergies. Operational synergies, which are the at the core of synergy approach, played a less significant role in value creation.

8.2 The motivations for growth

Growth strategy with a financial approach follows a usual pattern and aims at reaching four motivations, not necessarily all together.

As regard the pattern, two prerequisites should usually be met before making these decisions. First, the portfolio of existing businesses must deliver sound performance. Second, the firm must possess *excess resources* to allocate to new initiatives without it causing a weakening of the current level of the firm's competitiveness. The most important excess resources are free cash flows and general management competencies.

Once the two prerequisites are met, the leadership faces the question of whether to allocate the excess resources to develop the existing businesses, to start a new one, or to return cash flow to shareholders. In the case of separation between ownership and management, this dilemma should be carefully judged because self-interested managers may deploy strategies to maximize their own personal power and welfare and minimize their personal risk rather than maximize the interests of stakeholders.

If the firm decides to invest instead of distributing dividends, the next step will be to evaluate if existing businesses have reached their maturity and if it is still convenient, practicable or appropriate to use the excess cash to maintain or further advance their competitive positions. Notably, investing in existing businesses may not be practicable because an antitrust law could prohibit additional concentration in the industry or may not be appropriate because it would bring the firm out the comfort zone in taking risk, even if the reward is in line with greater returns.

If reinvestment is discarded, the firm can diversify and choose whether to target related or unrelated sectors. The latter are preferable when the following motivations prevail:

- Benefitting from financial synergies.
- Exploiting industry dynamics.
- Acquiring businesses undervalued by the market.
- Increasing the parent's ownership interest in a subsidiary.

8.2.1 Benefitting from financial synergies

Unrelated diversification always creates value through the realization of several types of financial synergies[3]:

1. Scale economies in financing.
2. Tax optimization.
3. Risk reduction.
4. Internal capital markets.

For example, when Zegna grows in adjacent segments, the risk that one or more events can have a similar impact on all businesses is not reduced, because a crisis in the men's clothing sector would have an impact on the formalwear business, men's casual clothing business, and the textile business. At the opposite, when De Agostini invests in gaming, it is clear that there is no correlation between the economic cycle of that industry and that of the publishing business.

Besides financial synergies, a conglomerate may also gain some additional advantages from operational synergies due to a transfer and sharing of resources between support activities of various value chains;[4] those of human resources management and infrastructure in particular. In that regard, consider the case of internal labor markets. Because conglomerates (all diversified firms, in general) have access to detailed information on their employees working in the businesses forming their portfolio, they have the opportunity to transfer them between businesses where it is most needed, to remove less competent managers and replace them with better ones, to adopt more sophisticated human resources management practices, and to develop a talent pool for the selection of future leaders. Of course, these benefits are greater in markets where information asymmetry is still prevalent.[5]

Although operational synergies between primary activities of the value chain are seldom in unrelated diversification, there are some exceptions. For example, the Virgin group is a conglomerate that uses its corporate brand to compete in the great majority of businesses in which it invests.

8.2.2 Exploiting industry dynamics

Unrelated diversification also allows for seizing opportunities that exist in new industries, which can go through a positive phase in their life cycle.

One of the motives that justified the investment of Edizione in Autogrill – that mainly operated in the motorway catering industry at the time of the acquisition in 1995 – was the awareness that the market was very attractive, ranking first in Europe. In addition, Autogrill had plenty of opportunities to further diversify horizontally or geographically because a process of deregulation and privatization was underway in Italy and in Europe as a whole.

We note that any type of diversification is seldom justified only by the hope to exploit industry dynamics: this motivation for growth usually combines with others. In the case of Autogrill, the investment not only allowed to exploit industry dynamics, but also to reduce the Edizione’s risk, to capture value by acquiring a company at a good price, and to take advantage of operational synergies in human resource management. Concerning the latter point, the motorway catering industry and the fashion retail business (The Benetton Group) share a similar critical success factor: the efficient management of the network of points of sales. This commonality let Edizione transfer a core group of key managers to Autogrill: among them was Gianmaria Tondato, who was first engaged in the internationalization of Autogrill in the American market, and then appointed Chief Executive Officer in 2003.

8.2.3 Acquisitions of firms undervalued by the market

Another motivation to diversify unrelatedly comes from the opportunity to acquire a firm at a good price, or that is undervalued by the market, as recommended by the capital markets logic. Edizione was able to spot that Autogrill was underpriced and had a value potential not fully captured by the previous owners. The De Agostini group had the same intuition when it bought Lottomatica during the process of privatization launched by the Italian State at the beginning of the 2000s.

Of course, nothing happens per chance. Firms requires specific competences in managing M&As to exploit this motive for diversification.

8.2.4 Increasing the parent's ownership interest

We have concentrated the discussion on unrelated diversification (or unrelated exploration), but a growth strategy with a financial approach includes a second option: financial reinforcement. As discussed in Chapter 7, reinforcement comes about when the holding company increases the parent's ownership interest in a subsidiary where control is retained. The power to control is exercised through the appointment of a representative of the holding in the subsidiary's governance structure.

Financial reinforcement can even translate into gaining full control of the subsidiary, whose reasons are usually ascribed to the need to restructure the subsidiary or manage a divesture process in an easier and more effective way.

Edizione controlled about 70 per cent of the outstanding shares of The Benetton Group in 2012. Then, it decided to buy the shares it did not already own through a delisting of the clothing and fashion chain, which struggled with failing earning and weak consumer spending. The market capitalization shrank from 4.2 billion euros in 2000 to 700 million euros before it went private. Afterwards, The Benetton Group was separated into three legal entities to facilitate a wide restructuring: Benetton (retail sector), Olimpias (manufacturing sector), and Edizione Property (real estate sector).

8.3 A historical perspective on diversification strategies

In Chapter 7 and in the first two sections of this chapter, we have discussed the theme of diversification, both related and unrelated. At this point, we deem it essential to take a brief look at the history of ideas on this subject, to have a sense of where they might go in the future.

Many scholars have found that the historical perspective has unfolded over time following some patterns. By observing U.S. data, Grant notes that (Figure 8.1):

- From the 1950s to the 1980s, the search for new areas of growth led to the creation of multibusiness firms. Initially, related diversification was the preferred choice. Then, unrelated diversification became popular among medium and large-sized companies. The peak of the trend was in the 1970s, with the rise of many conglomerates that became examples of good management practices.
- From the 1980s until the early 1990s, the tendency reversed because unrelated diversification proved to be inefficient and underperforming. Many firms reduced their scope, opting for narrow related diversification.
- From the 1990s, the emphasis on shareholder value switched corporate priorities from growth to profitability and accelerated a broad refocusing on few interrelated core businesses.
- Starting at the beginning of the current century, diversification made a big comeback following the recognition that growth and profitability can be achieved together if these strategies are based on key strengths in firm's resources and can rely on corporate headquarters that are well designed to implement effective parenting strategy decisions.

Figure 8.1 **The historical evolution of diversification strategies (related and non-related)**

MANAGEMENT PRIORITIES	• Search for growth	• Improvement of performance of diversified firms	• Creation of value for shareholders	• Corporate advantage
DEVELOPMENTS IN CORPORATE STRATEGY	• Emergence of conglomerates • Firms diversify in related sectors	• Emphasis on related diversification • Search for syn- ergies	• Focus on core businesses • Restructuring of firms	• Bundling of products and solutions for clients • Alliances • Creation of options for growth
TOOLS AND CONCEPTS OF STRATEGY	• Financial anal- ysis • Spread of *M form* structures • Creation of corporate planning departments	• Economies of scope • Portfolio planning models • Modern financial theory	• Maximization of shareholder value • Transaction costs analysis • Distinctive competence • Dominant logic	• Dynamic capacities • Advantage from “added value logic” • Real options

1960 1970 1980 1990 2000 2012

Source: R.M. Grant, *Contemporary Strategy Analysis*, 8th ed., Chichester, Wiley, 2013, p. 349. Copyright © 2010, 2013 Robert M. Grant.

The transition from diversification to refocusing depends on the progress of managerial trends and the rising of new ideas about strategic management. For instance, in the 1970s there was strong confidence about the universality of general management principles and a belief that industry-specific knowledge was of a less relevance to succeed. This view was abandoned – if not denied – in the 1990s with the spread of the resource-based theory. More recently, the recognition of the importance of strategic alliances has brought the related diversification to the fore again.

In facts, strategic alliances allow for the exploitation of synergies between independent organizations without using hierarchical control.

Regarding this debate, Markides wisely observed that “diversification as a corporate strategy goes in and out of vogue on a regular basis,”[6] whereas Grant ironically stated that “diversification is like sex: its attractions are obvious, often irresistible, yet the experience is often disappointing.”[7]

Beyond managerial trends, there are at least two factors to depict the up-and-down views on diversification. First, there are the arbitrage opportunities on capital markets. In countries where markets do not verify the efficient market hypothesis, there is a greater incentive to diversify. Second, the evolution of ownership structure matters, especially when it comes to analyze the history of a single firm. In firms with weak ownership as public companies, diversification could serve managers, not shareholders. The interests of managers can be the achievement of prestige, power, gratification, or to exercise favoritism towards some stakeholders. On the opposite side, if the number of public companies increases and capital markets are efficient, the diversification should theoretically decrease as we will explain in the next sections. In firms with strong ownership as family businesses, diversification can thrive because it can reduce the personal risk of owners by reducing firm risk, can protect the preservation of the family dynasty over the long term, or can increase the variety of career choices for future generations. Still remaining in the field of family businesses, a refocusing strategy gains popularity to preserve family control, to avoid the distribution of power and influence to non-family managers or to solve family conflicts. This happens when the family divests in one or more businesses in order to raise financial resources to prune family trees or cash out family branches not interested in continuing the entrepreneurial dream.[8]

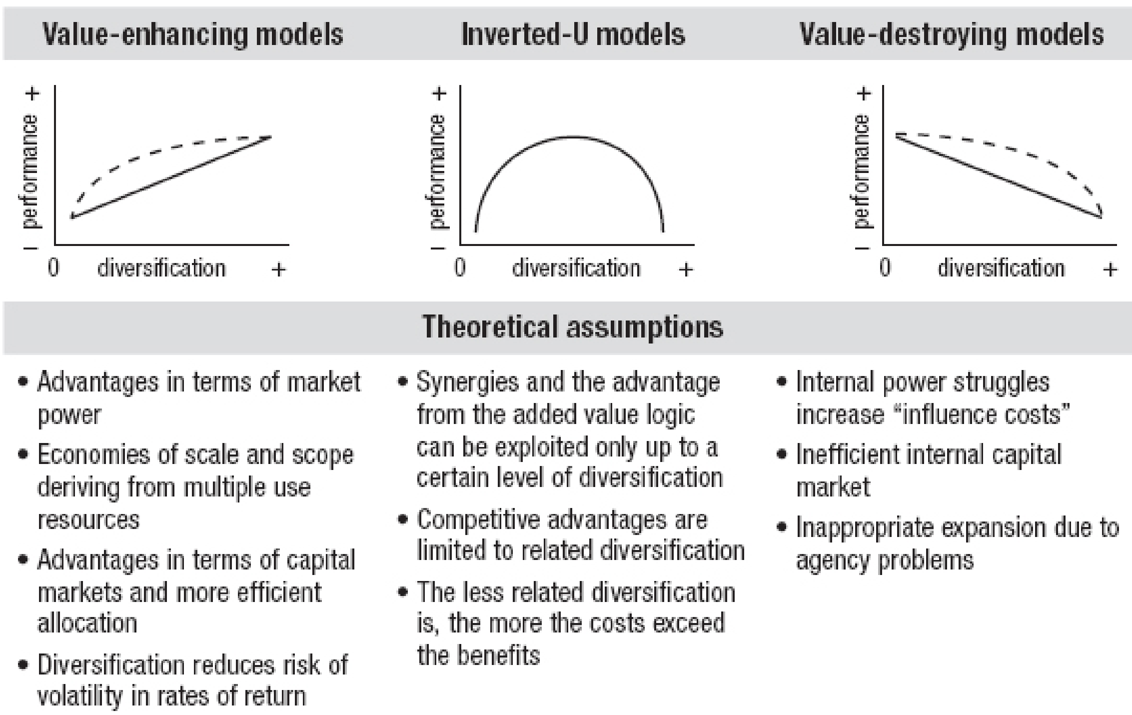
8.4 Diversification and performance

How do diversified firms perform relative to single business firm? Does related diversification outperform unrelated diversification?

To answer these questions it is crucial to measure the level of diversification, which is determined by two factors: the number of businesses in which the firm has invested, and the relatedness between businesses.[9] A firm with a low level of diversification invests in two or more related businesses of which one is dominant in portfolio. A medium to high level of diversification is associated with firms investing in a growing number of related businesses. A very high level of diversification stands for conglomerates or firms with a portfolio of unrelated businesses.

There are three theoretical models explaining the impact of diversification on performance as illustrated in Figure 8.2: the "linear model," the "inverted-U model," and the "intermediate model." The linear model and the intermediate model can be used to predict that diversification and performance are positively correlated. The studies building on these models fall into the category of "value enhancing models." The same models can be used to demonstrate a negative correlation between variables. In this circumstance, the studies belong in the category of "value destroying model." Finally, the inverted-U model, a combination of the previous ones, argues that there is an optimal level of diversification, also influenced by contingencies such as industry concentration, market efficiency, and country maturity. Moderately diversified firms outperform both single business firms and highly diversified groups.

Figure 8.2 **General models and empirical evidence on the relationship between degree of diversification and performance**



Source: developed by authors based on M. Nippa, U. Pidun, H. Rubner, "Corporate Portfolio Management: Appraising Four Decades of Academic Research," *Academy of Management Perspectives*, 25(4), 2011, p. 55.

The existence of different models gives clear evidence that there is no proof of unconditional advantages of diversification. Notwithstanding, the inverted U-model emerges as the most highly cited among scholars,[10] who believe that market power, internal capital market efficiency reasoning, economies of scale and scope are the most important drivers for creating value, while an excess of internal control and coordination costs can lead to value destruction. The latter costs are due to:[11]

- *Information-processing constraints,* limits of the corporate headquarters' ability to monitor the performance of business unit managers.

- *Internal politics*, which emerge in the relationships between the corporate headquarters and businesses.
- *Incentive problems*, difficulties to design effective and customized incentive mechanisms for each business unit manager.
- *Lack of responsiveness*, decision-making delays and bureaucratic use of time by corporate headquarters that prevent businesses from quickly reacting to opportunities or threats in their industries.

To complete the analysis, we cannot forget that the measurement of the diversification effect on performance is also a general statistical problem related to observational studies, which can depend on:

1. *Survival principle*, the panel data considers only survivors – firms that succeed in diversification – assuming that the behavior of a randomly selected group of competitive firms can be taken as efficient. But what happened to firms that diversified and did not survive over time?
2. *Categorization*, the measurement of relatedness relays on the Standard Industry Classification (SIC) system that presents issues of strategic and accounting inconsistency for three reasons. First, it is a discreet metric that does not properly take into account the variety of relatedness. Second, it is subject to classification errors (SIC classification). Third, it does not recognize that relatedness depends on sharing and transfer of resources, not on similarities between industries in technologies and products.[12]
3. *Industry's effect*, each firm pursues its own diversification model by combining businesses from different industries. If the analysis of firm's performance does not consider the industry effect on profitability, the risk is to compare profitability data incorrectly.
4. *Causation*, a correlation between variables is confused with causation. This mistake occurs when studies do not provide statistical information to check whether diversification improves profitability or if good profitability allows firms to diversify.
5. *Self-selection bias*, the panel data consists of poor performers that diversify in search of growth opportunities because they have no other alternatives in their existing business.[13]

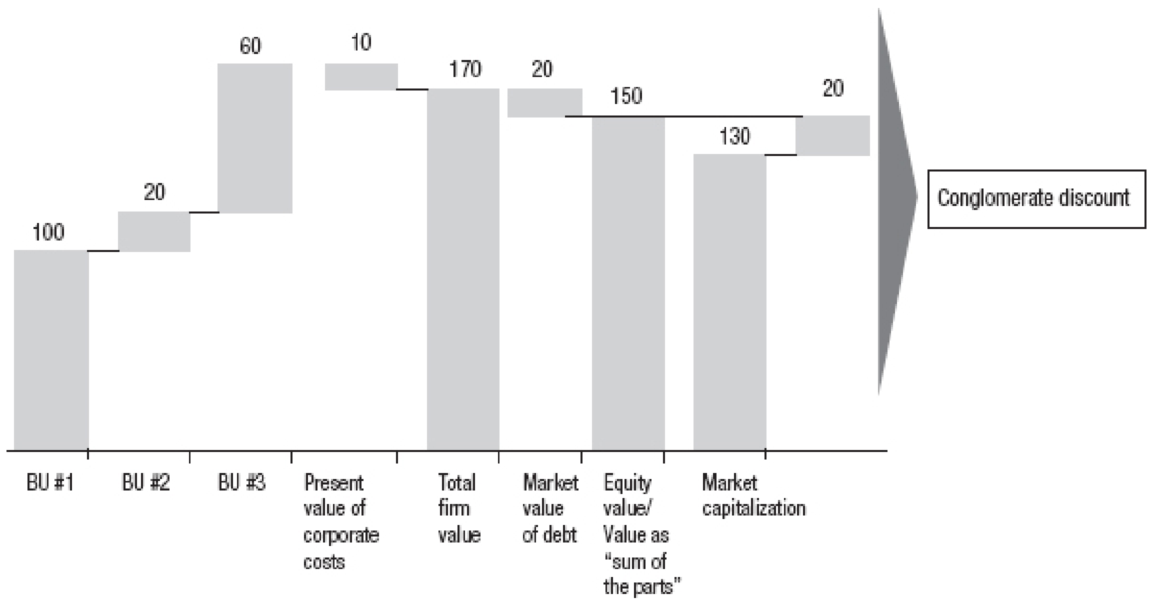
Finally, it is worth noting what a recent study has reported: instead of concentrating the debate on recognizing the contradictions in the relationship, scholars and practitioners should spend more energy on codifying *how* diversification can create value and *how* a firm should manage a certain level of diversification. Today, the right question is not what relationship exists between diversification and performance, but what organizational mechanisms are to be designed and implemented to create value.[14]

8.5 The diversification or conglomerate discount

For decades, the financial markets have also expressed skepticism towards diversified companies. This skepticism has translated into the existence of a "diversification discount" or a "*conglomerate discount*" measured as:

- The discount applied by the market to the value of the stock of diversified firms relative to single business firms.[15]
- The discount applied by the market to the value of the stock of diversified firms relative to their fair value, calculated through the sum-of-the-parts valuation (Figure 8.3).

Figure 8.3 The conglomerate discount



Why does the diversification discount exist? The discount exists because markets (or better, financial market analysts) believe that shareholder diversification is more efficient than corporate diversification, or a specific corporate diversification model does not create enough value. In particular, corporate diversification is criticized because companies risk:

- Investing insufficiently in the most profitable businesses in the portfolio.
- Cross-subsidizing poor performer businesses instead of restructuring or divesting them.
- Paying expensive control premiums for M&As to diversify.
- Implementing burdensome and unproductive organizational structures at the corporate level.

By and large, the discount is higher for conglomerates than for firms that diversify relatedly. In addition, there are other variables influencing the correlation:

- *Control model*. The discount is higher for firms with high ownership concentration, such as a family holding company. The reverse is true in public companies where leadership should be more subject to the "pressure of financial markets" and more incentivized to serve shareholders' interests when taking diversification decisions.
- *Capital markets efficiency*. The discount is higher if investors are able to diversify their portfolio of assets, without having to purchase shareholdings in diversified firms.[16]
- *Market performance*. The discount increases with the market volatility. Some studies report that after the bankruptcy of Lehman Brothers, there was a general expansion in the value of the diversification discount.[17]
- *Corporate disclosure*. The discount grows if corporate disclosure is poor or limited. If the market does not have all of the information to properly assess the corporate strategy, the stock value will necessarily be affected.
- *Other characteristics of firms.* The discount can vary as a function of a firm's leverage, level of organizational complexity, and the size of the corporate headquarters.
- *Financial behavior of investors and financial analysts.* The discount can be altered by bias and errors of investors and financial analysts (such as self-deception, heuristic simplification, emotion, or social influence) that can lead to a more or less positive evaluation of some businesses.

Goldman Sachs published a very interesting study on over 20 European conglomerates that shows how these firms can still do a great deal with their corporate strategy to influence their market value.[18] Indeed, the study reports that: (1) the diversification discount is equal to 29 percent on average; (2) in the first quartile it amounts to 18 percent on average; and (3) the median in the third quartile is 43 per cent.[19]

8.6 Good practices for successful growth with a financial approach

Because unrelated diversification will always have a place in our management culture, some good practices can be followed to increase the chances of success:[20]

- Carefully evaluate whether there are possibilities for further growth with a synergy approach before undertaking an unrelated diversification.
- Adopt an investment policy to outline the investment goals and objectives and the general rules to select and manage shareholdings (Figure 8.4). Such a policy should be detailed enough to guide the decision-making, but also flexible enough to seize opportunities at short notice.
- Gain a full understanding of the new businesses by comprehending the relevant industry dynamics and critical success factors. This has paramount importance to avoid a negative influence by corporate headquarters on decision-making at the business level.
- Develop an effective corporate governance for the holding company and its shareholdings.
- Support the increase of a firm's competitiveness through the appointment of good directors, leaders and managers.
- Implement choices to add value to businesses by corporate headquarters, not to destroy it.
- Manage the financial policy to not take on excess leverage and risks.
- Hold enough equity to deal with potential investment failures or unforeseeable events.
- Assess the possibility of divesting a shareholding if a business cannot reach a leadership position in the industry where it competes.

Figure 8.4 The investment policy of Exor Group

Most of our portfolio is made up of companies in which we are the leading shareholder. Alongside these companies, we have investments in two areas:

- **Financial**: A concentrated equity portfolio of minority stakes in companies chosen based on fundamental research.
- **Seeds**: Investments in early-stage companies, through which we back talented founders, continuing our history of entrepreneurship and innovation.

Across all of our companies and investments, we apply some common criteria:

1. **Understanding** – We invest only when we understand
   We learn from practitioners who bring deep knowledge
   We form our own opinions and strive to be aware of what we don't know
2. **People** – We back talent and look for cultural alignment
   We believe people are what makes the difference
   We know that behavior is as important as skills or knowledge
3. **Value** – We decide based on value
   We will assess intrinsic and potential value to invest when the price is right

Source: exor.com/pages/companies-investment/overview

[1] For a discussion of the issue of growth with a synergy approach, see Chapter 7.

[2] To understand the limited presence of conglomerates in the top 100 Italian groups by size, consider that 90 percent of them were active in only one sector, while only 10 percent were active in two or more sectors according to the AUB Observatory.

[3] For a discussion of the subject of synergies, see Chapter 4.

[4] The support activities of the value chain are: procurement, technology development, human resources management, firm infrastructure; see *ibid*.

[5] On this subject, see Anand and Jayanti (2005).

[6] Markides (1997).

[7] Grant (2013), p. 361.

[8] For a discussion of the impact of ownership structures on corporate strategy decisions, see Chapter 13.

[9] On this subject, see Fontana and Boccarelli (2015), par. 5.4.

[10] As Grant writes: "Despite many empirical studies since the 1960s, consistent, systematic relationships between diversification and performance are lacking. Beyond a certain threshold,

high levels of diversification appear to be associated with lower profitability, probably because of the organizational complexity that diversification creates." Grant (2013), p. 358.

[11] Furrer (2011), ch. 6.

[12] For other errors also linked to the correctness of performance data of the single businesses reported by the corporate headquarters, see also Villalonga (2004), Fan and Lang (2000).

[13] Lang and Stulz (1994).

[14] Ahuja and Novelli (2017).

[15] Lang and Stulz (1994), Berger and Ofek (1995), and Servaes (1996).

[16] Anand and Jayanti (2005).

[17] Goldman Sachs Group (2012).

[18] Anand and Jayanti (2005).

[19] *Ibid*.

[20] On this issue, see Markides (1997) and with specific reference to family firms, see, among others, Anderson and Reeb (2003).

9 Modes of Growth

by *Paolo Morosetti*

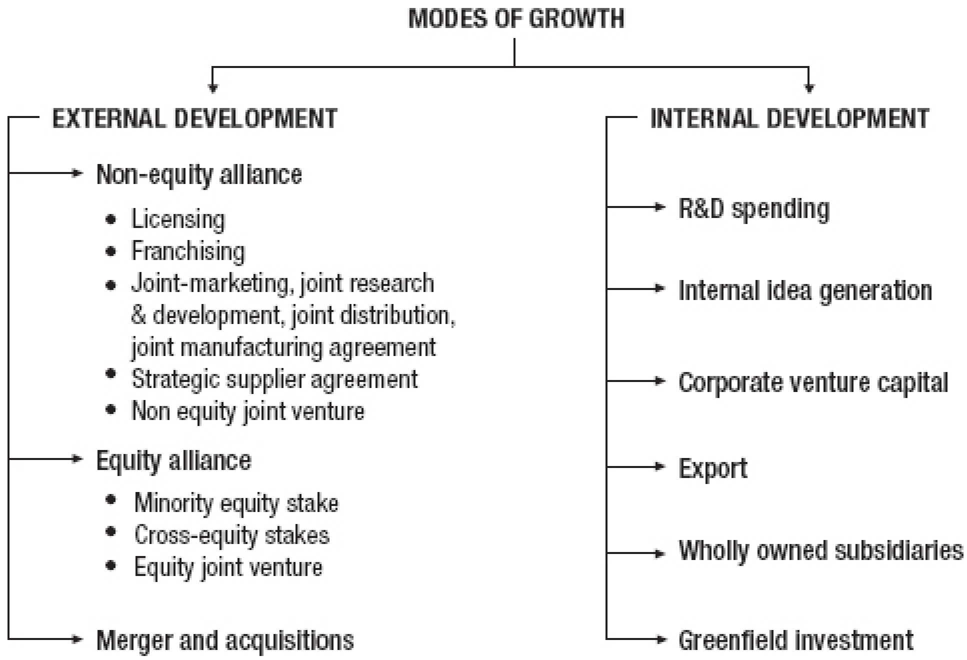
9.1 The growth tree

To prosper in the midst of fierce competition, multibusiness firms make use of growth strategies to find new ways of building a corporate advantage. These strategies include three fundamental elements: the direction, the rationale, and the mode of growth.[1] This chapter discusses the modes of growth understood as the organizational ways to grow or the pathways to obtain resources to expand the scale and to modify the corporate scope.

The variety of growth modes is captured by the "growth tree," which develops along two branches (Figure 9.1):

- *Internal development*, which is based on an innovation or a recombination of resources controlled by the firm.
- *External development*, which includes non-equity alliances, equity alliances, and mergers and acquisitions (M&As). The former allows for borrowing needed resources from third parties. The latter allows for acquiring what is needed to meet the firm's ambitions.

Figure 9.1 The growth tree



Internal development is also referred to as internal or organic growth, while external development is called external or inorganic growth.

9.2 Internal development

An internal development is a recombination of a firm's resources with greater or lesser innovation. The main benefits and risks linked to this option are described in Table 9.1.

Table 9.1 Benefits and risks of internal development[2]

Benefits	Risks
• Gradual financial commitment • Possibility to exploit the mechanism of learning-by-doing (learning) • Higher likelihood that the outcome will be more accepted by the organization	• Slower pace of growth • Execution risk to deliver innovation and change • Lack of dynamic capabilities[2]

and aligned with the corporate culture (cultural fit) • Stimulus for corporate entrepreneurship • Possibility to control the process and to adapt it to changes emerging in the internal and external environment (control)	• Risk of intensifying competition. This circumstance arises if the internal growth adds production capacity while demand does not increase with the same pace (other conditions being equal) • Risk of launching an initiative not able to reach critical mass

The Bertazzoni case exemplifies the capability of growing internally. Bertazzoni is a medium-sized family-controlled company headquartered in Guastalla, in the North of Italy, which has manufactured and marketed kitchen appliances since 1882. In the last decade, the leadership has decided to transform the firm from a cooking specialist to full-line brand. As a cooking specialist, Bertazzoni was concentrated on the assembly and sale of stoves, ovens, and cooking tops for the Italian and international markets. As a full-line brand, it offers a full suite of appliances consisting of a line of hoods, refrigerators, and dishwashers, in addition to traditional products already offered on the market. That transformation has benefited from the execution of various internal development initiatives.

Most people think that internal development is merely a result of research and development activities. This is not true. Innovation can take in place in all the firm's departments thanks to "internal idea generation" processes or the role of "intrapreneurs"[3]: people capable of translating their passions and creativity into new business ideas.

Well-known companies such as Alcatel-Lucent (ALU), General Electric, Intel, Google, and 3M have designed and implemented structured programs to mobilize the entrepreneurial skills of their employees to develop new business ideas. Among the different experiences, that of IBM stands out by results achieved. In brief, in 2001 IBM established the Emerging Business Opportunity (EBO) program to look beyond the orthodoxies of the core businesses and to find "The Next Big Thing" to power new growth engines. An EBO is an internally generated idea that can become a profitable, billion-dollar business within five to seven years thanks to the support of experienced IBM executive champion. Among the new businesses launched through this program, those of digital media, life science and Linux are the most popular.

Internal development can also be pursued through corporate venture capital investments[4] that allow new business models to incubate during the early stages. These corporate funds are more frequently launched by large firms that have an excess of resources (tangible assets, intangible assets or organizational competencies) to invest.

Consider the case of BP Venture, the fund was set up more than ten years ago by BP, one of the largest global energy companies, that is vertically integrated to find, extract, and supply oil, natural gas, and petroleum, and also involved in the production and supply of energy from low-carbon and renewable sources. The mission of BP Venture is to improve and transform BP's core businesses by identifying and investing in private, high growth, game-changing technology companies, which have the potential of accelerating innovation across the entire energy spectrum. Since its launch, BP Venture has partnered with more than 40 startup companies and invested more than 500 million dollars.[5]

Corporate venture capital should not be understood as an alternative to R&D spending or internal idea generation. Rather, it complements traditional paths of internal development in a context less influenced by barriers to change that too often prevent innovation on a large scale in established organizations.

Finally, if the strategic priority is to unlock global expansion, the internal development options are export, the establishment of wholly-owned subsidiaries, and greenfield investments.[6]

9.3 Alliances[7]

Amplifon has exploited franchising agreements, through its subsidiary Miracle-Ear, to grow in the United States. Fiat Chrysler Automobiles signed an equity joint venture with Crédit Agricole Consumer Finance, named FCA Bank, to provide financial support for the sale of automobiles and commercial vehicles to customers and the dealer network. Starbucks closed a deal granting Nestlé the perpetual rights to market Starbucks Consumer Packaged Goods and Foodservice Products globally, outside the company's coffee shops.

There is a myriad of firms of all sizes that form alliances to grow. All of them recognize the value of closer interaction and open sharing but want to maintain a certain level of autonomy and independence to avoid being controlled by their partners.

Alliances are based on contractual agreements in which two or more parties take on mutual commitments, i.e. contractual obligations, to cooperate and coordinate in order to reach the common objectives that constitute the subject of the collaboration. Parties remain independent organizations and can cooperate without any share of equity, through minority equity investments, or through common equity structures like joint ventures. Upon expiration of the contract, they can agree on automatic renewals, subject to the fulfillment of certain conditions, or they can intentionally exclude this right and open negotiations to form new alliances.

The duration of collaborations spans from medium to long-term depending on the set of common goals. In the automobile sector, for example, product alliances have an average duration of between five and ten years since this is the time frame for the development and exploitation of technologies related to a car, such as engines and platforms. Instead, the global coffee alliance between Starbucks and Nestlé is perpetual.

From an organizational standpoint, an alliance is a governance structure that is more similar to market exchanges in the case of non-equity alliances, or to a hierarchy for equity alliances.

Selecting the best governance structure for an alliance requires considering the following contextual factors:

- The volume of coordination costs at the time of alliance formation. The greater the volume of coordination costs, the more hierarchical the governance structure is.
- The complexity of arrangements. The higher the complexity, the more hierarchical the governance structure is due to the higher coordination costs of the alliance.
- The degree of interaction between parties. The more the interaction, the less hierarchical control is required.
- The existence of prior collaborations between the parties. There is evidence that past experience reduces moral hazard and decreases the need for tight hierarchical controls in managing the alliances.[8]

Notably, non-equity alliances are more suited to managing a collaboration with limited goals and a low degree of integration between the parties in the execution phase, and that takes place in a context marked by low uncertainty on future developments. To the contrary, equity alliances are used to face complex interactions, disincentive moral hazard and opportunistic behaviors, and manage more uncertainty. It is widely acknowledged an equity commitment strengthens the trusting relationships between parties.[9]

Concerning the variety of alliances, the most common types are:

- *Licensing*, a contractual agreement that grants a subject the right to use the intellectual property of another subject, generally in exchange for a royalty.
- *Franchising*, a contractual agreement by which one firm (franchisor) grants another firm (franchisee) the right to exploit a series of intellectual properties and commercial and industrial assets in order to offer certain goods or services on the market.
- *Joint marketing*, *joint research & development*, *joint distribution* or *joint manufacturing agreements*, a contractual agreement that governs the collaboration between two or more parties so that value chain activities are carried out in a joint and coordinated manner within a specific functional area.
- *Strategic supplier agreement*, a contractual agreement through which a firm builds a long-term collaborative relationship with a supplier to engage it in a process of continuous improvement. The relationship often features an early supplier's involvement in product development.
- *Non-equity joint venture*, any generic contractual agreement which governs the mutual obligations that the counterparties assume to reach common goals.[10]

Whereas, the most common types of equity alliances are:

- *Minority equity stake*, an agreement between two parties combined with the purchase of a minority stake in the capital of one of the two by the other participant in the alliance. As an alternative to purchase, a party may reach the same goal by subscribing a capital increase reserved for it.
- *Cross-equity stakes*, an agreement between two parties combined with the purchase of a minority equity stake based on reciprocity.

- *Equity joint venture*, an agreement between two parties to enter into a separate business venture together. This entails the establishment of a new legal entity. Equity joint ventures can be majority, equal, or minority, depending on how the ownership rights are distributed between the shareholders.

Turning to the benefits and risks associated with alliances, the most important are detailed in Table 9.2.

Table 9.2 Benefits and risks of alliances

Benefits	Risks
For all type of alliances: • Speed to market • Access to complementary resources and markets • Limited financial commitment that can be adjusted as a function of results • Sharing of risks • Rivals may be less attracted to consider a relationship with the partnering firm because it is locked in the alliance (exclusivity) **For equity alliances:** • Possibility to better align interests of partners due to the equity investment (alignment)	• Risk of partial fulfillment of obligations by the partner or fulfillment not as expected due to moral hazard • Risk of opportunism based on asymmetric learning between the counterparties (learning race) • Risk of creating a competitor in case of an alliance between rivals • Limited control over growth process, being based on mutual collaboration • Limited adaptability of alliances to changes and uncertainty

9.4 Mergers and acquisitions[11]

A growing number of firms are turning to acquisitions as a mode of growth, as experienced by the Bauli group – a medium-sized Italian manufacturer and distributor of bakery products – that used this alternative to mitigate the dependence on its traditional business, that of holiday products. In 2006, Bauli acquired Doria, a manufacturer of biscuits; in 2009, the business unit with the Motta and Alemagna brands, previously owned by the Nestlé group; and in 2013, Bistefani, that allowed for broadening the portfolio of products and brands on the Italian market.

An acquisition (also referred to as a buyout) is a business combination or a corporate transaction through which a firm, the acquirer, takes ownership of stock, equity interests, or assets in another firm, the target. An acquisition can be of minority, majority, or of total or full control. Minority acquisitions involve less than 50 percent of the target, while majority acquisitions involve more than 50 percent and lead to a change of control. An acquisition of total control regards 100 percent of the ownership rights and is usually carry out if the acquirer intends to guide the post-merger integration process with the maximum autonomy and freedom. In addition, total control avoids potential conflicts between the majority and minority shareholders that emerge when the target firm must approve transactions in which the majority shareholder is the counterparty (known as transactions with related parties). In an acquisition, the acquirer is usually a larger firm than the target. If the reverse is true, the transaction is also known as reverse takeover.

A merger is a legal consolidation of two entities into one either by closing the old entities and forming a new one (consolidated merger) or by one company absorbing the other (statutory consolidated merger).

The main benefits and risks of mergers and acquisitions are summarized in Table 9.3.

Table 9.3 Benefits and risks of merger and acquisitions

Benefits	Risks
• Speed to market • Full control of the post-integration process (control) • Block of takeover bids on the target due to exclusive relationship with the acquirer (exclusivity) • Elimination of potential competitors in the market if the target is a rival	• Significant financial commitment • Risk of paying an excessive control premium in order to acquire controlling interests (cost of control) • Risk of acquiring a target that controls non-strategic resources, which are hard to sell or cannot be sold at convenient prices • Risk of failure of the post-acquisition integration • Risk of weakening the motivation of employees due to the implementation of

	significant changes necessary to extract value from the combination

The M&A market is more and more populated with "serial acquirers:" firms that acquire more and grow faster than their rivals. The LVMH group is a well-known example of a serial acquirer. The world's leading luxury group competes in multiple businesses spanning from wine and spirits, to fashion and leather goods, perfumes and cosmetics, watches and jewelry, and selective retailing. This portfolio of businesses is the result of a long sequence of acquisitions carried out in the last thirty years under the strong leadership of Bernard Arnault. The most recent transaction was announced in 2019: the acquisition of Tiffany & Co., the global luxury jeweler. The goal was to strengthen LVMH's position in jewelry by doubling the business and further increasing its presence in the United States. The equity value was of approximately €14.7 billion, the largest in the history of the French group.

9.5 Choosing the right mode of growth

How do firms select the right path to obtain specific resources they need to grow? We address this question by presenting two methods:

- The *buy or build* method, which assumes that the leadership should first consider an alliance or an acquisition to grow (the buy option). If not feasible, internal development (the build option) will be the favorite. This is true unless internal development was the only possible approach.
- The *build, borrow, or buy* method, which assumes that the leadership should first evaluate the feasibility of the build option. If not feasible, it should explore the possibility of building an alliance (the borrow option). If that is also not feasible, it should consider taking the buy option.

The first method is more popular among firms with a financial approach to corporate strategy and to support the development of businesses competing in mature industries, whereas the second method works better for firms with a synergy approach and for businesses still in early development stages, or involved in innovation.

Although the two models are conceptually different, they must ultimately reach the same conclusion.

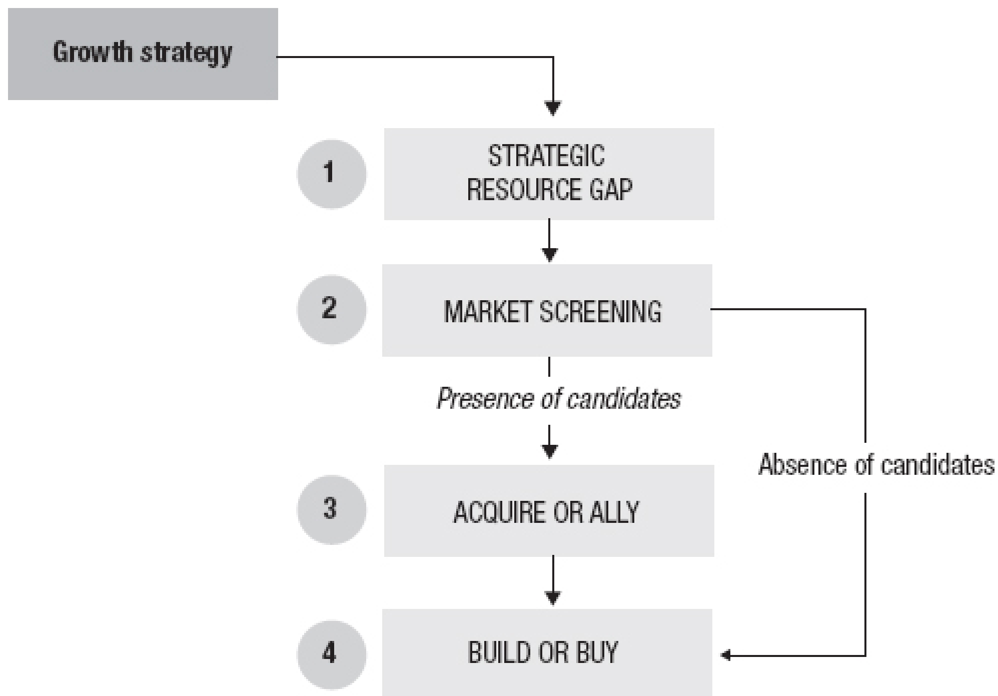
9.5.1 The buy or build method

In their textbook on corporate strategy, Puranam and Vanneste[12] describe an initial process of selecting between internal and external development to implement corporate diversification decisions, and then a process of choosing between different modes of external growth. Building on this contribution and the previous review of benefits and risks associated with each possible mode of growth, we have systematized a method to guide decision-making on this matter that relies on three assumptions:

1. Firms should first look at the market to take control of resources needed for growth.
2. The choice between internal and external growth depends on multiple factors, not a single one: transaction costs, regulatory requirements, strategic relevance of needed resources, tradability of resources, and M&A opportunities or challenges.
3. The choice of the mode of growth is never a matter of "all or nothing." Firms can combine internal and external paths to reinforce a business or to diversify. Therefore, some resources can be built in-house, others can be bought on markets, and many others can be borrowed by allying with third parties.

That said, the buy or build method is made up of four phases as shown in Figure 9.2.

Figure 9.2 **The buy or build method**



Source: developed by authors based on P. Puranam, B. Vanneste, *Corporate Strategy. Tools for Analysis and Decision-Making*, Cambridge, Cambridge University Press, 2016.

In the first phase, the firm identifies the strategic resource gap that consists of resources needed to pursue the growth goals. For example, if the strategy involves entry into a new geography, all resources needed to operate in the value chain associated with that geography will generate the gap to be filled.

The second phase entails a search for candidates for external development (the buy option). Candidates are provider of resources willing to form a non-equity or equity alliance (the ally option), or be a prospective takeover target (the acquire option). If candidates are available, the firm will move on to the third phase. On the contrary, to the fourth phase.

In the third phase, the firm checks whether candidates are interested in building an alliance or in negotiating an M&A or both. For each possible “candidate growth mode” combination, the firm identifies the set of benefits and risks together with the potential value creation. The recommended course of action will be the combination whose benefits outweigh the risks, and which creates the most value.

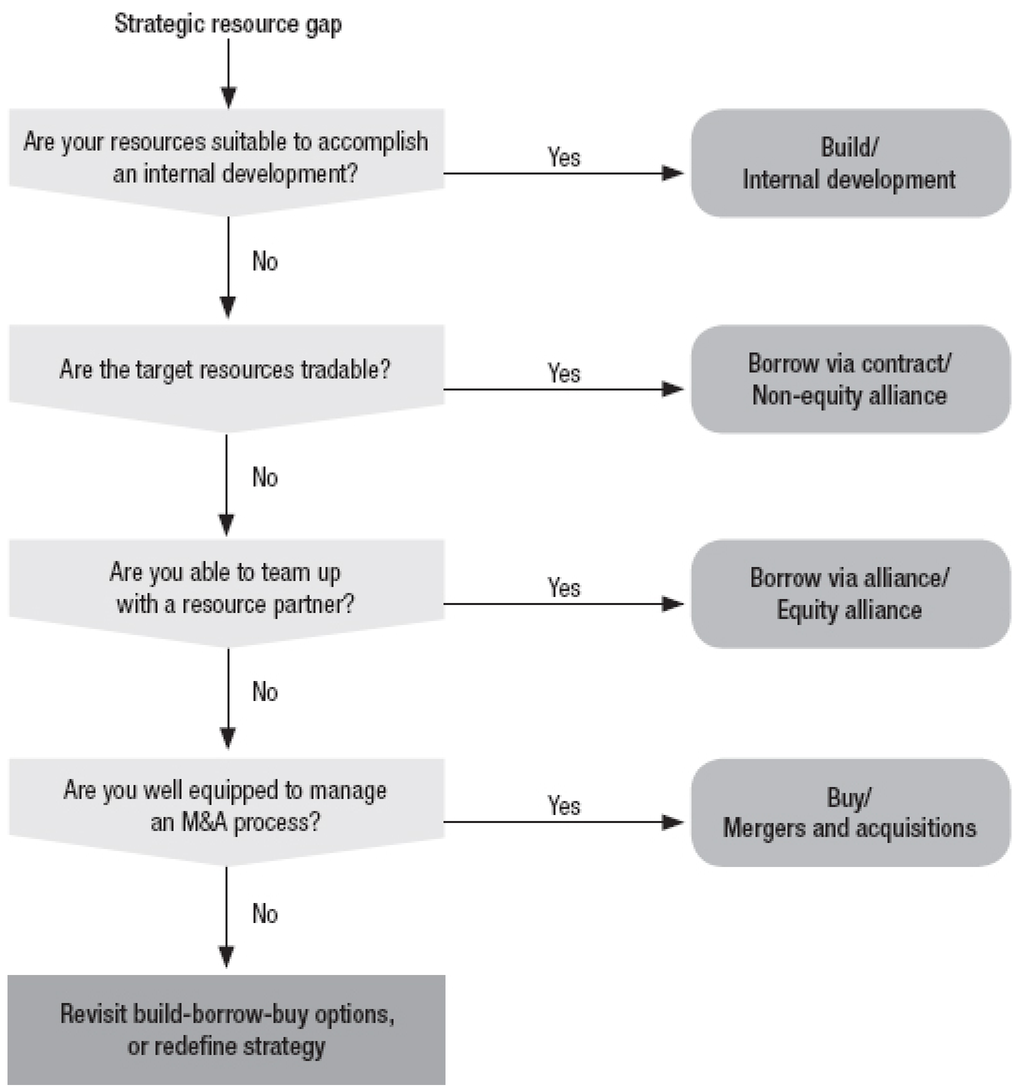
In the fourth and last phase, the firm delves into the internal development. If this option is the only one possible, its benefits, risks and potential value creation will be evaluated. However, we note that building resources that cannot become valuable makes little sense from a strategic perspective.

If a buy option was identified, the firm should ask itself: what would happen if the financial resources to invest in forming an alliance or making an M&A deal were allocated to internal development? Would this scenario be more convenient and strategically effective than the buy option? This sort of debate paves the way towards a final review of the buy option either to confirm or to give up.

9.5.2 The build, borrow, or buy method

The build, borrow or buy method (also known as the resource pathway framework) was devised by Capron and Mitchell,[13] and consists of a decision tree structured into four phases as illustrated in Figure 9.3.

Figure 9.3 The build, borrow, or buy method



Source: adapted by authors from Capron L., Mitchell W., *Build, Borrow, Or Buy: Solving the Growth Dilemma*, Harvard Business Review Press, 2012.

The starting point is similar to that of the previous method: the firm needs to identify its strategic resource gap in conjunction with its growth strategy. Once the gap has been clarified, the firm checks if it can be filled through internal development or the build option, which is recommended if:

- The new resources to develop internally allow to achieve a competitive advantage in a timely and cost-effective manner.
- The organization is responsive to innovation.

We observe that hubris and strong bias or a corporate culture focused too inwardly lead to an overestimation of the feasibility of internal developments.

If the build option is not feasible, the firm should ask itself whether the target resources are tradable. This is the precondition to forming a non-equity alliance or the “borrow via contract” option, whose main benefit is access to partner resources without facing the odds of managing an equity alliance or sustaining the cost of acquiring and integrating another firm. Two conditions must be jointly satisfied to build an alliance:

- Partners are able to frame key contractual elements with clarity and mutual benefits, detail clear terms and minimize uncertainty or potential conflicts in the future.
- The agreement includes terms preventing or penalizing opportunism. Trust is a prerequisite to bring a non-equity alliance to life, but without legal safeguards it is very difficult to formalize partnerships.

If the borrow via contract option is not practicable, the firm should explore the borrow via alliance option, understood as an equity joint venture, which works well when:

- The collaboration between partners is narrow or limited in scope. This means that it pursues few strategic goals and involves few partners’ functions and activities.
- The strategic goals between partners are compatible, i.e. partners are not in direct competition, provide key resources to the alliance equally, are not engaged in a learning race competition, and have similar alliance execution competencies.

The main difficulties in forming equity alliances are thus related to the reluctance to share the fruits of collaboration fairly, even when the payoff is greater than playing alone.

If a borrow via alliance option were also not possible, the firm would have no other choice but to evaluate a buy option whose success customarily depends on two basic conditions:

- The acquirer is capable of designing a clear integration map to combine its resources with those of the target, to extract value from the business combination.
- The acquirer is capable of identifying key people to retain for extracting value and planning the right measures to keep the motivation of the resulting organization high.

Whenever a firm doubts its competence to manage an M&A, it should seriously reconsider the build and borrow options or rethink completely its own growth strategy.

Finally, the build, borrow, or buy method does not directly mention the importance of conducting a financial analysis and an evaluation of the different options. This point remains essential to make good decisions and cannot be missed along the entire process of formulating a growth strategy.

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[1] For a discussion of growth strategies, refer to Chapter 6.

[2] A dynamic capability is "the capacity of an organization to purposefully create, extend, and modify its resource base" (Helfat et al. 2007).

[3] Intrapreneurship is a way for fostering and institutionalizing innovation within an established organization through specific structures, systems and a company culture that promotes creativity and excitement toward entrepreneurship. Intrapreneurs are employees who take direct responsibility for turning an idea into a new business. The term was coined in 1978 by business school founder Gifford Pinchot III (Corbett et al. 2018).

[4] Internal idea generation and internal corporate venture capital are two different processes to let firms unlock the potential of their workforce to identify business opportunities. This topic is one of the research areas of corporate entrepreneurship that investigates both the conditions enabling entrepreneurial development within an organization considered to be consolidated or mature, and the organizational mechanisms through which new ideas are generated and translated into new businesses. For further discussion of this point see Barringer and Bluedorn (1999); Garvin and Levesque (2006); Garzoni (2010); Ireland, Covin and Kuratko (2009); Sharma and Chrisman (1999); and Zahra, Randerson and Fayolle (2013).

[5] Data published on BP Venture's website in December 2019.

[6] For a discussion of international entry modes, see Chapter 12.

[7] For a discussion of alliances, see Chapter 11.

[8] Gulati and Singh (1998), Dent (2003).

[9] According to the transactions costs theory, equity alliances, and equity joint ventures in particular, are to be preferred to non-equity alliances when four circumstances are present: (i) strong uncertainties on the development of collaboration, that can lead to both positive or negative effects; (ii) information asymmetry ex ante on the real contribution that a partner can contribute to the success of the alliance; (iii) specific investments of resources in the initiative that cannot be reused in other ways in the event of failure of the alliance; and (iv) strong risk of opportunistic behavior by partners.

[10] For example, in international tender contracts, a non-equity joint venture is usually used to allow multiple actors, with complementary know-how, and potentially residing in different countries, to participate in an international tender and collaborate in the execution of the contract, if they are selected as winners.

[11] For a discussion of M&A operations, see Chapter 10.

[12] Puranam and Vanneste (2016).

[13] Capron and Mitchell (2010; 2012).

10 Mergers and Acquisitions

by *Paolo Morosetti*

10.1 Becoming a successful acquirer

According to the latest report by J.P. Morgan,[1] in 2018 the global M&A market reached the value of 4.1 trillion dollars, with activities that remained robust across all types of deal. Transaction volumes were driven both by external factors, such as positive global growth and the low cost of debt, and by internal ones, such as the desire of firms to drive change across industries, geographies, and organizations.

M&As represent the best pathway to grow when some factors combine, such as the existence of slack internal resources, the lack of resource tradability, and the need to act swiftly, as described in the previous chapter. However, these business combinations are not always a panacea for creating value, as demonstrated by popular cases as the marriage between Daimler-Benz and Chrysler in 1998. In 2001, the value of the combined company had dropped to roughly that of Daimler-Benz before the merger. Nine years after the announcement, the experiment was eventually abandoned by the German manufacturer, which then sold Chrysler to a private equity group.

In this chapter, we will explain why "not all M&A are alike"[2] and why it is crucial to equip firms with specific competencies to manage the entire M&A process, from deal making to post-deal evaluation.

Becoming a successful acquirer does not happen by accident. It is the result of three fundamental good practices:

- Aligning M&A motivations to the firm's growth strategy.

- Taking a rigorous approach to evaluate the target and to negotiate a fair or reasonable price.
- Creating value through a tailored approach to post-acquisition integration (or post-merger integration).[3]

Before discussing these practices, we will tackle two central questions in the literature: the M&A waves and the M&A performance.

10.2 M&A waves

Strong and compelling empirical studies show that the M&A market follows cyclical trends, which are not a random walk process.[4] Over 50% of the acquisitions occurring in the last century took place in waves,[5] which are periods of expansion or of intense M&A activities during which stock prices of listed companies experience a dramatic surge, then maintain that peak for several years, which are eventually followed by a sharp tumble when the wave comes to a close. Given that the length of M&A waves is not always the same, the end often coincides with a recession or a crisis.

Notably, since the 1980s, four significant waves have taken place.[6]

- The first wave (1980s) was fueled by the elimination of inefficiencies created by the spread of conglomerates in the 1970s, and by the desire of firms to refocus on a few core businesses. Internationally, it was facilitated by favorable economic conditions and the introduction of financial innovations such as the development of junk bonds. In some countries such as the United States, the deregulation of some industries helped the expansion of the market. This M&A wave is ultimately remembered for an increasing number of hostile takeovers, a widespread use of leveraged buyouts (LBO), and a significant number of bust-up takeovers.[7]
- The second wave (1990s) was driven by an increase in globalization, an acceleration in technological progress, and a fast pace of deregulation and privatization of many industries such as banking, telecommunications, and broadcasting. This cycle was marked by the disappearance of the hostility so dominant in the previous period.

Transactions were mainly financed through equity rather than debt, while there was a big boom in cross-board M&As. Consider that the estimated stock value of M&A deals concluded between 1998 and 2000 was equal to approximately 4 trillion dollars globally, a significantly higher figure than the total value of deals recorded in the previous 30 years.[8] According to some studies, approximately 40 percent of that value can be traced to cross-border acquisitions.[9]

- The third wave dates to the period from 2003 to 2007, when the value of transactions reached a level similar to the one observed in the previous cycle. The expansion phase benefitted from various factors: the monetary stimulus of central banks which kept interests low, the further development of private equity funds which stimulated levered acquisitions, the process of globalization, a consolidation trend in numerous industries, a further relinquishment of diversification (including related diversification), the technological progress driven by the spread of internet, and the first rise of shareholder activism.
- The fourth and most recent wave of M&As reached its peak in 2014-2015: over 8 trillion dollars of transactions in two years, globally.[10] This cycle was triggered both by traditional forces, including the global economic recovery and the expansive monetary policies by central banks, and by new ones, such as the acquisition appetite of Chinese and Asian firms and the emergence of new investors such as sovereign wealth funds and family offices.

The cyclical nature of M&A waves has been studied through many theoretical lenses to reach the conclusion that it depends on a combination of external and internal factors:

- The *neoclassical theory* argues that this phenomenon is the outcome of macro-environmental or industry shocks forcing firms to respond through increased acquisition of assets. There are several types of shocks positively correlated with waves, including economic, regulatory and technological ones, and those resulting from the launch of radical financial innovations. In addition, according to this theory, firms also need to have capital and liquidity to trigger a cycle, otherwise the likelihood to acquire will be low.

- The *market evaluation framework* states that the waves are correlated with the development of capital markets, namely with the periods of over-optimism and pessimism.
- The *behavioral theories* consider the psychology of managers. On the one hand, M&As can be a way to pursue managerial interests as the "empire building."[11] On the other hand, they can be motivated by managerial hubris (managers are overconfident of their ability to extract value from business combinations) or herd behavior (managers mimic the investment behavior of other managers).

Why are M&A waves significant for corporate strategy? Understanding and anticipating M&A waves might provide opportunities either to invest or to divest, in keeping with the principles of the capital markets logic. This is what happened in 2013 when the Loro Piana group, a celebrated brand in the fashion industry, was acquired by the French giant LVMH. The enterprise value of Loro Piana was assessed with the record multiple of 21.5 times the EBITDA reported in the 2012 financial statements.[12] For the Loro Piana family, the rich capital gain was one of the key reasons leading to the sale of their business and legacy. For LVMH, the generous acquisition premium was the price to pay to further consolidate its leadership in the luxury-fashion value chain and to outpace its direct rivals.

10.3 M&A performance

Do M&As create value? If so, how do they create rather than destroy value? This debate dates back to the 1960s, and there are three main schools of thought[13] that have developed important findings on the subject:

- The *financial economics school*, which solves the question by analyzing the share price and abnormal returns of the acquiring firm and that of the target in a certain time frame around the announcement.
- The *strategic management school*, which studies the business factors influencing post-acquisition performance, such as the level of resource

relatedness between the acquirer and the target or acquired firm and the capability of the acquirer to orchestrate the integration phase.

- The *organizational behavior school,* which investigates the impact of cultural and organizational fit, learning, and employee motivation on performance.

Unfortunately, after more than six decades, the empirical evidence is still controversial also due to some methodological differences which is good to know:

- *Research approaches*. Event study and the outcome analysis are the two main approaches used to investigate the phenomenon. The first analyzes stock market reactions to the events that occur at the time of an M&A or in its aftermath. The second compares the pre- and post-acquisition performance.
- *Performance variables*. Performance can be measured through: financial or accounting variables (such as the return on assets), market variables (such as the abnormal returns[14] of the stocks involved in the deal) or non-financial variables (such as the outcome of qualitative assessments on the degrees of synergy realization). They can refer to various time horizons: short, medium or long-term. They can monitor the deal execution at the task level, transaction level, or firm level. For example, a firm can measure (i) the completion of a specific task, such the integration of IT systems; (ii) the value created by the exploitation of synergies; or (iii) the improvement of the firm's overall performance.
- *Data availability*. Data set can include observations about the acquired firm (or the target), the acquiring firm (or the acquirer), the combined entity or the shareholders of the former or the latter.

In light of the above, what can we say with reasonable certainty on the question of whether M&As create value? Building on empirical evidence enjoying broad acceptance, a few basic facts are:[15]

- Acquisitions, alliances, and internal development initiatives have similar rates of success. It is not true that acquisitions destroy more or

create less value than other growth modes (i.e. alliances and internal development initiatives).
- Acquirers and their shareholders do not profit from an acquisition (on average). That conclusion is reached by using both accounting and financial criteria to measure the success rate.
- There is high variance in the distribution of M&A performance, both inter-firm and intra-firm. Some acquirers have higher success rates than others, and some acquisitions create much more value than others, even when they are carried out by the same firm.
- Most of the target's shareholders benefit from an acquisition. The takeover announcement increases the value of the target firm's stock by 30 percent (on average). This also means that the acquirer is generally willing to pay a control premium to acquire the target.
- M&A activities create value because the combined market capitalization of the acquirer and the target increases by about 2 percent (on average).

However, here is a difference between making acquisitions and making them work. Achieving winning results and becoming a successful acquirer requires mastering specific competencies.[16]

10.4 Typologies of M&As

There is an abundance of typologies of M&As in the literature, and many have become common currency among practitioners. We have selected three of them to understand why not all M&As are not similar.

The first typology suggests the following classification:[17]

- *Overcapacity M&A*, which takes place in mature industries that have a substantial overcapacity and where weaker players can be bought out by their more powerful rivals. Through these deals, the acquirer can strengthen its competitive advantage by leveraging a greater market share and the deployment of more efficient business models. The post-acquisition integration phase usually provides for rationalization of production capacity installed, reduction of staff to increase labor productivity, and organizational changes of various kinds.

- *Geographic roll-up M&A*, which happens in the early stage of the industry's life cycle, not in the maturity phase, and assumes that the acquirer buys out small local competitors or small players in adjacent geographies whose growth potential is hampered by some circumstances such as ownership losing the commitment to growth, problems in leadership succession, or difficulties in raising funds.[18]
- *Product or market extension M&A*, which lets the acquirer extend the product range, enter new industry segments or improve its global reach. With regard to the latter motivation, such M&As differ from the geographic rollout because the organizational impact of the internationalization strategy is more pervasive.
- *M&A as R&D*, which is meant as an alternative way of conducting research and development in-house (these deals may fall within corporate venture capital investments). Many large firms outsource their R&D investments to small firms and then acquire those that successfully innovate. For instance, from 2010 to 2018, Apple made 20 acquisitions focused on artificial intelligence, followed by Google with 14, and Microsoft with 10.[19]
- *Industry convergence M&A,* which aims at combining firms from different industries undergoing radical changes to create new corporate portfolio models.

A second typology groups M&As in four well-known types:

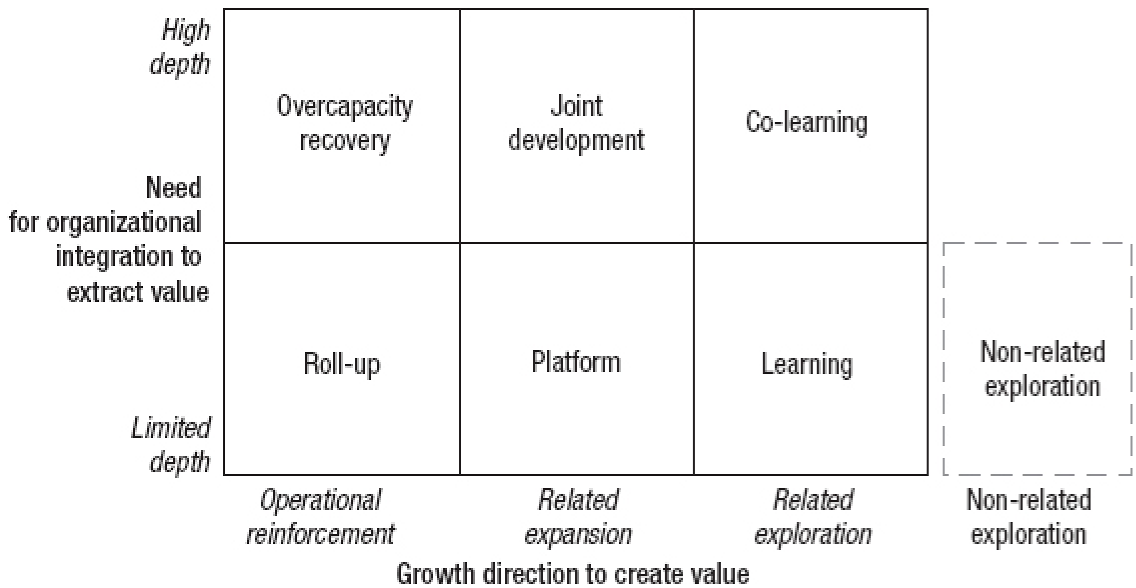
- *Horizontal M&A*, which aims to increasing the scale of existing businesses by expanding product or market lines, also geographically.
- *Vertical M&A*, which is a way to deal with critical interdependencies along the industry's value chain by combining firms operating on different stages through vertical integration.
- *Concentric M&A*, which makes it possible to diversify into a related business.
- *Conglomerates M&A*, which is done to diversify into unrelated businesses.

The last typology we present identifies seven types of M&As as a function of their direction of growth and their need of integration. The first variable is discrete and spans from operational reinforcement, to related expansion, related exploration, and non-related exploration.[20] The second variable is continuous and describes to what extent the acquired firm will be integrated into the acquirer to extract value from the business combination. At one end, integration may be limited (or narrow) to keep the (legal and/or organizational) autonomy of the acquired firm. On the opposite, integration may be pervasive (or broad) to reduce or even annul the autonomy.[21]

The seven types of M&As are illustrated in "The Value Map Through M&As" (Figure 10.1). They can be described as follows:

- *Roll-up M&A*, which allows the transfer of the acquirer's core strengths to the acquiring firm to improve its competitiveness or to restructure it in case of disappointing performance.
- *Overcapacity M&A*, which aims to broadly integrate the organization of the acquired firm into that of the acquiring firm to gain efficiency and market power advantages potentially in all value chain activities. This M&A can also aim at reducing the industry's overcapacity through a consolidation among rivals.
- *Platform M&A*, which intends to exploit efficiency, growth and market power advantages through a narrow integration.
- *Joint development M&A*, which aims to benefit from efficiency, growth and market power advantages through a broad integration.
- *Learning M&A*, which plans to invest in a firm that does not require to be broadly integrated to create value. These investments are often understood as strategic growth bets not too far from the core; however, they need to be managed by leaving a large autonomy to the leadership of the new business.
- *Co-learning M&A*: which aims at integrating the acquired firm and the acquiring firm to radically transform the corporate strategy model and learn how to manage new corporate resources.
- *Non-related exploration M&A*, which allows for a non-related diversification or an exploration in keeping with the guidelines of the financial approach.

Figure 10.1 **The Value Map Through M&As**



Source: elaboration based on M. Zollo, A. Di Mase, "Integrazione su misura: il segreto delle acquisizioni di successo," *Harvard Business Review Italia*, April 2008; R.T. Uhlaner, A.S. West, "Picking up the pace of M&A requires big changes in a company's processes and organization – even if the deals are smaller," *McKinsey on Finance*, Spring 2008.

Consider the acquisition of Gilette by P&G in 2005. At the time, P&G was the largest consumer products company in the world, while Gillette was a similar player but smaller in size and with a portfolio of brands and products often not in direct competition. The deal gave P&G more control over shelf space at the nation's premium retailers and wholesalers and the access of new business lines like Gilette razors, Duracell batteries, Braun, and Oral-B brands dental care products. This deal can be placed in the quadrant of Joint Development M&A because the growth direction was mainly a related expansion while post-integration plan was based on a broad integration of Gilette in P&G.

Of course, complex M&A operations like that of P&G-Gilette can be analyzed at a more granular level by splitting them into single parts, i.e. the businesses of the target. For instance, the acquisition of the Braun's businesses could be classified as a Learning M&A for P&G, while other

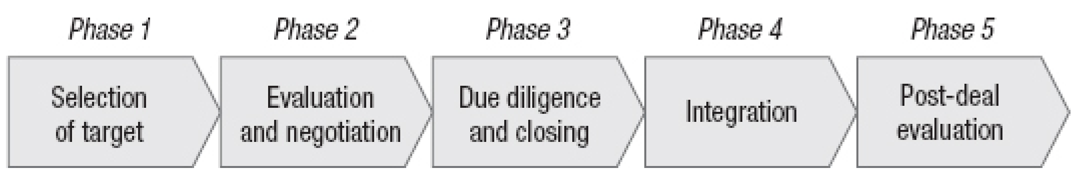
P&G's businesses could be described as Joint Development M&As. The distinction is relevant because it helps to sharpen the integration plan.

10.5 The M&A process

We divide the M&A process into the following phases (Figure 10.2):

1. Identification of target.
2. Valuation and negotiation.
3. Due diligence and closing.
4. Integration.
5. Post-deal evaluation.

Figure 10.2 The M&A process



This sequence doesn't include an initial phase of strategic formulation as reported in other contributions[22] that abound in literature and practice. This choice is consistent with our way of understanding the strategic management process which places the discussion of why and whether to do an M&A in the planning phase, while the M&A process in the implementation phase.

The two main actors of the process are the acquiring firm that plays the role of the *buyer* in making the deal and the *seller*, understood as those who are selling a stake in the business by divesting shares or assets to another firm.

The buyer invests considerable resources to check the existence of a strategic and organizational fit with the target, to negotiate the acquisition price which leaves the seller satisfied and the buyer still able to create value, and to integrate the target. The seller is completely concentrated on negotiating the price and defining the terms and conditions of the agreement during the process.

Beyond the buyer and the seller, other players are usually involved in the process to provide their expertise, such as investment bankers, lawyers and advisors of both parties, and other experts who can be engaged in the due diligence phase to carry out tasks requiring a high level of specialization.

Paradoxically, a recent study reached the conclusion that financial acquirers are more successful than corporate acquirers in creating value through M&A, even if they don't benefit from operational synergies.[23] This depends on their stronger ability to manage the process, since they treat each deal as a core part of their business. Conversely, firms with a synergy approach to corporate strategy are often more focused on the post-acquisition integration phase than on previous ones, namely the negotiation.

10.5.1 Phase 1: Identification of target

To build the target pipeline, buyers can follow three approaches:

- *Informal*, buyers pinpoint potential targets through their network of professional and personal relationships.
- *Systematic*, buyers give an assignment to third parties (such as an advisor) to assist them in the process.
- *Opportunistic*, buyers are contacted by a seller seeking to sale a company or assets.

In the informal or systematic approach, the process begins with the establishment of criteria to screen the market and find the potential targets or nominees. These criteria can include a list of the target's preferred characteristics such as size, financial performance, business mix, global footprint or degree of internationalization, product line offering, market positioning, technological aspects, intellectual property, ownership and governance structure, and availability of tax benefits.

Once the nominees are found, they are subject to a financial and operational analysis on the basis of documents available in the public domain (annual report, income statement, balance sheet, cash flow statements and market data like Price-Earnings, price to book value, market share, industry growth prospects, etc.). In addition, a preliminary or tentative valuation of potential targets is carried out usually by applying valuation multiples.

As soon as a list of potential targets is available, the most suitable ones are contacted to check their interest to start serious negotiations.

10.5.2 Phase 2: Valuation and negotiation

If the target shows an interest in the deal, then the process goes on to reach an initial agreement. As a first step, the two parties sign a letter of confidentiality[24] to share and exchange critical and strategic information concerning financial, commercial, operational, personnel, legal and tax aspects. With this information, the buyer can appraise the potential of synergies, draft an acquisition business plan, and thus calculate the stand-alone value of the target and its maximum value, which will include the benefits of expected synergies. The maximum value is calculated by applying the discount cash flow method.

As soon as the buyer has a clear understanding of the target's characteristics, the target's value and its potential increase through synergies, and the way by which an integration could be realized, then the negotiation process will begin. The first step consists of drafting the letter of intent (also known as an indication of interest), which can serve as a benchmark to assess whether the buyer and the seller are working in the same direction and with the same end-goal in mind. In addition, the process of negotiating the letter of intent can also help buyer and seller understand if they are well-suited for each other. If they are not, it is better to walk away from the process at this stage.

A letter of intent states the offer or dealing price (or the purchase price) and the chief terms and conditions of the deal, which may cover the deal structure (i.e. stock sale, merger, asset sale), times and manners of payment,[25] closing day, closing conditions, ways of conducting the due diligence, and an exclusivity provision which restricts one or both parties from entering into talks with any other party for a specific period of time.

Letters of intent can be binding or non binding. The latter is a pre-contractual agreement, or a preliminary sales agreement.

Before beginning the negotiation process, the buyer should also clarify which deal-making approach it intends to adopt: *capturing value* or *creating value*. With the first approach, the buyer aims at negotiating a purchase price close or below the stand-alone value of the target. With the second approach, the buyer agrees to transfer part of the potential value generated by expected synergies to the seller in the form of an acquisition premium.[26]

10.5.3 Phase 3: Due diligence and closing

Once the letter of intent is signed, the due diligence will begin. Due diligence is an investigation or an audit to verify the transaction value drivers, to increase the confidence that value can really be created, and to mitigate risks. This audit is tied to different work streams that cover different areas such as accounting, financial, tax, commercial, legal, operational, and/or environmental aspects.

Due diligence is also a way to deepen the knowledge of the target's leadership and management and a way to gather information that can support the final round of negotiation of the Sale and Purchase Agreement (SAP).

The signing of the SAP is formally followed by the closing of the deal. In private companies, signing and closing essentially correspond because key stakeholders are kept informed along the process. In listed companies, the closing is more often temporally separated from the signing because regulators and some investors could become aware of the transaction only when the SAP is announced. At this point, they can make their voice heard and influence the closing phase. Therefore, only when the closing conditions have been met and the buyer has obtained all the necessary consents and fulfilled all legal requirements, can the deal be considered closed.

During this phase, the buyer normally arranges the financing of the deal. If the acquisition is paid in cash, the acquirer can use its internal resources or may borrow from the market. If the acquisition is a stock deal, then the buyer should issue new shares to the target's shareholders based on a negotiated swap ratio. The parties may also agree upon an earn-out mechanism: part of the price will be paid in the future depending on the performance of the target company.

10.5.4 Phase 4: Integration

The integration starts with the closing of the deal and consists of a sequence of changes concerning the strategy and organization of the acquiring firm and the target to form the new business combination. This process is driven by the assumptions reported in the acquisition plan, which can be adjusted along the way to look at emerging opportunities or unanticipated problems. Integration unfolds along two key dimensions:[27]

- Strategic and organizational integration, which includes a set of activities to coordinate, align, or recombine the resources of both organizations to extract value.
- Sociocultural integration, which regards all human, social, and cultural aspects of the process to keep employee motivation high, to strengthen a sense of belonging to the new organization, and to build a new corporate culture.[28]

10.5.5 Phase 5: Post-deal evaluation

The M&A process does not end with the integration. Whether an M&A succeeds or fails, a post-deal evaluation stands out as the last phase of the process whose advantages are to codify, share, and learn from the acquisition experience. There are many practices to foster learning, such as the implementation of a knowledge management system to encode organizational routines and lessons learned in manuals, procedures or guidelines.

Post-deal evaluation is crucial for firms wishing to make use of M&As again, since acquisition experience has a positive influence on performance under certain conditions, as explained in Box 10.1.

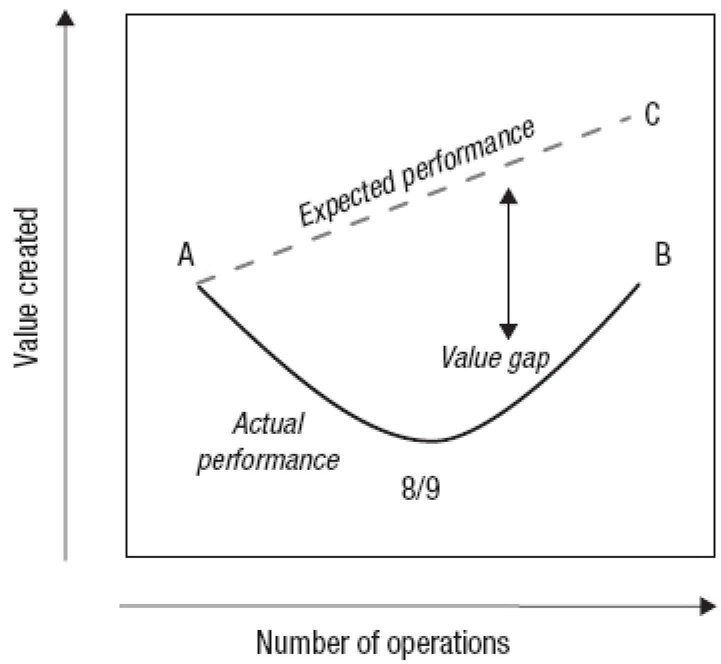
Box 10.1 Acquisition experience in M&A

Can firms learn to manage acquisitions through direct experience or learning-by-doing?

The main research findings in the field cast a shadow on the link between the learning curve theory and M&A performance because this relationship has been proven to be of limited relevance. Notwithstanding, there are some insights that deserve to be known due to their managerial implications:

- A great number of empirical studies agree on the fact that prior experience is not automatically associated with an increase in the success rate of subsequent operations; sometimes, it is even negatively related. This means that lessons learned cannot be generalized and applied in future decisions, because the subsequent acquisition could be completely different than the prior one with regard to rationales, negotiation tactics, and post-integration strategy. In a nutshell, replicating an "old recipe" in a new context only risks hurting performance.
- Empirical studies show that experience with prior, small, related acquisitions is negatively related to post-deal performance of large acquisitions.[29] In addition, the more similar a firm's acquisition targets are to its prior targets, the better they perform within an acquisition process.[30] This implies that if the acquirer recognizes the type of acquisition to make and applies the lessons from a prior, but similar experience, the likelihood that the experience will positively influence performance increases.
- A group of prominent scholars[31] has proposed a contingency model to explain the relationship between learning and M&A performance, which is depicted as non-linear with a U-shaped form as reported in **Figure 10.3**. Before a threshold level of experience, learning has a negative impact on performance – on average - because the acquirers tend to apply lessons learned in prior experiences to new contexts uncritically or mistakenly. After a threshold level of experience, acquirers gain sufficient experience to exploit learning properly. This threshold has been estimated in 8/9 acquisitions.

Figure 10.3 **The learning curve in M&A operations**



Source: M. Zollo, A. Di Mase, "Integrazione su misura: il segreto delle acquisizioni di successo," *Harvard Business Review Italia*, April 2008.

10.6 Managing the integration phase

To what extend should the acquired firm be integrated in the acquiring one? How long should the integration phase last?

To face these questions the acquirer must find the right balance between the search of an optimal level of integration to get synergies and extract value from collaboration and the definition of an acceptable level of disruption of the acquired firm due to the execution of the integration, to protect the stand alone value of the investment.

This balance is not so easy to reach. For example, if key employees of the acquiring firm don't agree on the logic underlying the integration plan or they believe it is a threat for their careers instead of an opportunity, they may quit. In this way, the acquirer risks losing control on distinctive competencies.

To face the challenge of integration, theory and practice suggest taking a tailored approach. In order to explain what it means, first we need to describe the organizational choices of linking and grouping and what are the variety of integration archetypes.

10.6.1 Key organizational choices to integrate

Integration occurs through linking and grouping, which are not mutually exclusive. With regards to linking, it includes actions creating informational channels, facilitating the transfer of knowledge and practices, and aligning the employees' incentives.[32] The most important linking options are:

- Changes in governance to influence strategy and the main business policies (for example, the replacement of the Chief Executive Officer or key people in the management team).[33]
- Standardization of management systems such as strategic planning, performance management and reporting, information systems, and human resource management.
- Standardization of processes to support the transfer of knowledge.
- Use of "lateral relationships" to facilitate joint decision processes between the acquirer and the acquired firm by cutting across the lines of authority. Lateral relationships include the set-up of liaison roles, the design of task forces, committees, or teams, and the appointment of integrating roles.

Linking does not radically change the organization of the acquired firm, which maintains a high level of autonomy and its own identity.[34]

To the contrary, grouping comprehends choices modifying the organizational structure of the acquired firm to reduce or annul its level of autonomy. The most important ones are:

- Consolidation of one or more organizational units of the acquired firm into those of the acquired firm.
- Redesign of one or more organizational units through changes in their authority, goals, performance management, incentives, and procedures.

- Change of the reporting and functional lines.

10.6.2 Integration archetypes

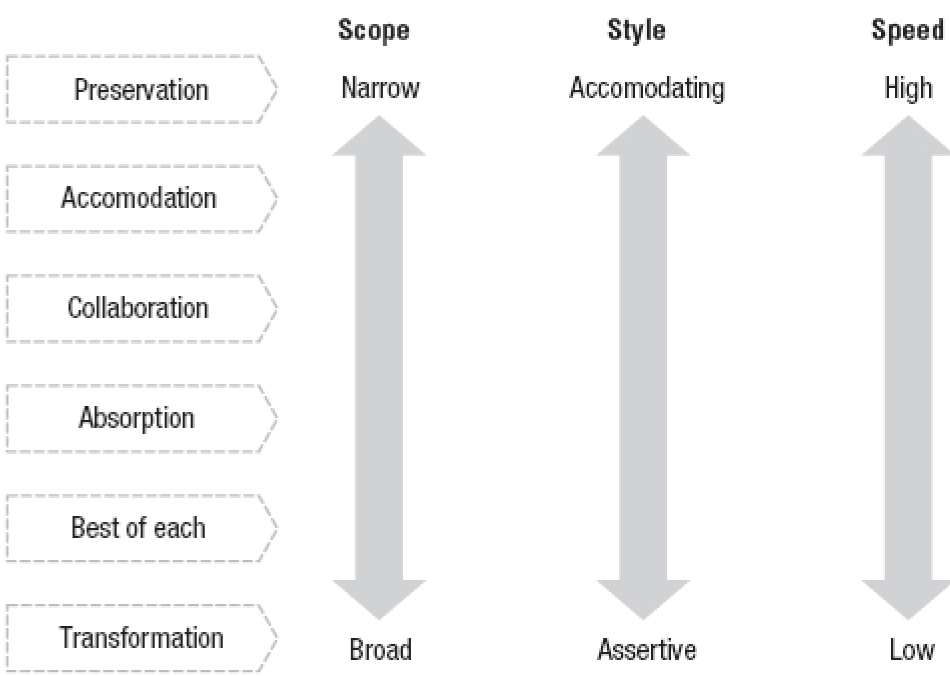
The notions of linking and grouping are useful for delineating six integration archetypes:

- *Preservation,* the archetype entails very few actions on the acquired firm, which keeps its legal identity and a broad autonomy. The acquirer exercises its power of control mainly through the appointment of its own representation in the governance bodies. The standardization of some systems such as strategic planning, performance management, and reporting can also be put in place.
- *Accommodation,* compared to the previous case, the archetype also involves a standardization of other systems and processes (such as human resource management or information system). With this approach, the transfer of competencies between parties begins to become more relevant.
- *Collaboration,* with respect to accommodation, the archetype also contemplates a wide use of lateral relationships.
- *Absorption,* the integration involves both linking and grouping actions. The latter consists in the full consolidation of the acquired firm into the acquirer, which often ceases to exist as a legal entity and loses autonomy.
- *Best of each,* beyond implementing various linking actions, the archetype envisages a selective consolidation of the acquired firm into the structure of the acquirer. Therefore, the acquired firm tends to survive as a business unit at the end of the integration, even if some of its organizational units are likely to be centralized at the corporate level.
- *Transformation,* this archetype is the deepest and most complex among the six illustrated. It results in a radical rethink of both organizations to preserve the strengths of the original ones without adopting the structure of either. For example, if the acquirer has a multi-divisional form and the acquired firm a functional form, the evolution toward a matrix can be considered a transformation.

As illustrated in Figure 10.4, the archetypes differ from one another in three properties:

- *Scope*, the archetype can have a narrow (or limited) or broad (or pervasive) impact on organizational structures.
- *Style*, the archetype presupposes different manners of behaving in managing the relationships between the acquirer and the acquired firm and its stakeholders. On the one hand, the acquired can be very accommodating. On the other hand, it can be more assertive and less inclined to seek compromises.
- *Speed*, if the archetype can be made operational in the short term, the speed will be high. The opposite happens if the implementation demands a longer time.

Figure 10.4 Relationship between integration archetypes and properties of depth, sensitivity, and speed



The three properties are related among them. For example, a broad scope is associated with an extensive use of grouping choices to reduce the autonomy of the acquiring firm. In that case the speed of integration will be low because changes in structures require longer times to be negotiated and carried out, while the style to adopt in engaging stakeholders will be fair, but assertive. Otherwise, a continuous negotiation of compromises would risk jeopardizing the original plan due to the rising of barriers to change.

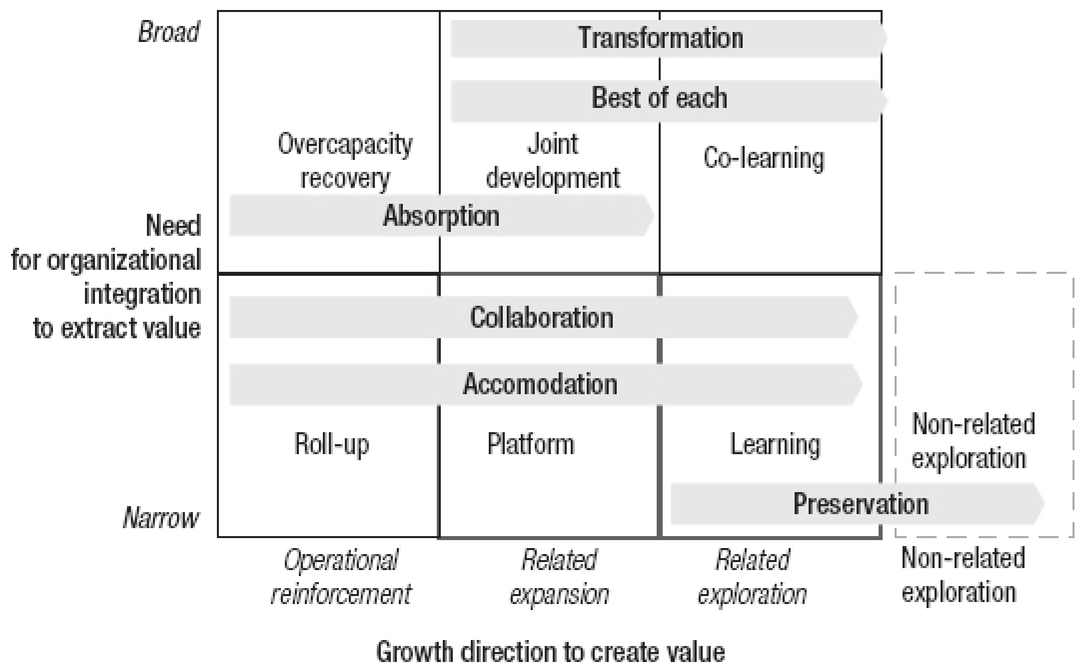
10.6.3 Choosing a tailored approach to integration

At this point, we have clarified all elements to make understandable the notion of a tailored approach to integration, which is divided in two stages:[35]

1. Selecting an integration archetype consistent with the M&A strategy.
2. Adapting the archetype to the characteristics of the acquired firm and the acquirer.

To select the archetype, the acquirer can use the "The Value Map Through M&A" modified as illustrated in Figure 10.5. For each quadrant, we suggest the options to evaluate.

Figure 10.5 The relationship between type of M&A operation and archetypes of integration



Once an archetype has been selected, the acquirer can adapt it based on certain characteristics:

- The relative scale of the acquired firm compared with the acquirer.
- The similarity of the two organizations with respect to products, processes, and cultures.
- The quality of resources and the performance of the acquired firm.

If the scale of the acquired firm is greater than that of the acquirer, it is recommended to limit the level of integration at the beginning or start at the bottom, to increase along the way. If a strong similarity between both organizations exists, an integration with a broader scope can be considered favorably. If the acquired firm possesses valuable resources (i.e. a competitive advantage) and good performance, a broader integration is not recommended (at least at the beginning). The risk of disruption would be very high.

Finally, before coming to the final choice, it is necessary to check the quality of the acquirer's M&A competences. If the acquirer suffers from a lack of competence, the process should start with a narrow scope which can increase over time. This facilitates a sort of learning by doing. Of course, the acquirer can team up with advisors to avoid making beginners' mistakes.

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[1] JPMorgan Chase & Co. (2019).

[2] Bower (2001).

[3] Jemison and Sitkin (1986).

[4] Faulkner, Teerikangas and Joseph (2012).

[5] Gaughan (2002); Gugler, Mueller and Weichselbaumer (2012); Hartford (2005).

[6] Three merger and acquisition waves took place between the turn of the 19th century and the 1980s.

[7] In a bust-up takeover the buyer sells various assets of the target company to repay debt that financed the takeover.

[8] Caiazza (2011); Child, Faulkner and Pitkethly (2001); Henry (2002).

[9] Hitt, Harrison and Ireland (2001).

[10] JPMorgan Chase & Co. (2017).

[11] Excessive growth or excessive investments are two forms that empire building may take on. Increasing firm size (or diversifying operations) could serve managers to achieve their private interests as status, power, compensation, and prestige.

[12] The estimate of a multiplier of 21.5 times EBITA is cited in *ilsole24ore.com* (2013).

[13] For an in-depth analysis of the three school of thoughts, see Zollo and Singh (2004), Zollo and Meier (2008), and Bauer and Matzler (2014).

[14] An event study is a method of statistical analysis of the behavior of a series of figures for the period around a specific event. In the analysis of M&A operations, the statistics subject to analysis are typically the daily abnormal returns of a stock, calculated as the difference between the actual return observed and that anticipated. That analysis can be carried out taking into consideration a temporal window of a few days before or after the operation, or longer time spans, even of a number of months. For further discussion of the studies that use this method to study the relationship between M&A performance, see Zollo and Meier (2008).

[15] Capron and Pistre (2002); Puranam and Vanneste (2016); Zollo and Di Mase (2008); Haleblian et al. (2009).

[16] The theme of the decision-making context in which M&A operations take place is examined by Cortesi (2000) and Haspeslagh and Jemison (1991).

[17] Bower (2001).

[18] For further discussion of the concept of location advantage, see Chapter 7.

[19] Data reported in the “AI trends Report 2019”, CBInsight.

[20] For a discussion of the directions of growth, see Chapters 6 and 7.

[21] The concept of level of integration is examined in Section 10.5.

[22] Kumar and Sharma (2019).

[23] Ajello and Watkins (2000).

[24] The letter of confidentiality is also known as a confidentiality agreement or a non-disclosure agreement.

[25] There are two methods of payment for an acquisition (which can be combined): payment in cash or in shares. The choice depends on the wishes of the seller and on financial evaluations, as well as tax and accounting evaluations.

[26] Haspeslagh and Jamison (1991).

[27] For a review of the process of integration: Graebner et al. (2017).

[28] Galpin, Alpin and Herndon (2007); Haspeslagh and Jamison (1991); Pablo (1994); Shrivastava (1986).

[29] Ellis et al. (2011).

[30] Zollo and Singh (2004).

[31] Haleblian and Finkelstein (1999); Zollo and Leshchinskii (1999), Zollo and Singh (2004), Fubini, Colin and Zollo (2008).

[32] Puranam and Vanneste (2016).

[33] In the category of linking, we also include changes in corporate governance, which are not part of organisational choices on the basis of the notion of parenting strategy described in Chapter 1.

[34] Prashant, Singh and Raman (2009) introduce the concept of partnership as an approach to post-merger integration, that has numerous similarities with the concept of linking as it has been defined here. In particular, the partnering approach is understood as “keeping an acquisition structurally separate and maintaining its own identity and organization.” In essence, some acquisitions can be managed as alliances on an organizational level.

[35] For further discussion of the subject of integration processes and the need to plan them with a contingent logic, see Haspeslagh and Jemison (1991) and Zollo and Di Mase (2008).

11 Strategic Alliances

by *Guido Corbetta*

11.1 Definition and classifications

The popularity of alliances is increasing in many industries and countries due to different factors[1] such as the need for larger and larger investments in the development of products or in production; the need to seize risky technological opportunities; the progress of globalization, which pushes firms to enter and compete in an increasing number of countries; and the opportunity to respond to new demand trends. The number of strategic alliances is growing considerably also because many medium to large-sized firms tend to form multiple alliances[2] to achieve their strategic goals and to avoid remaining dependent on a single partner.[3]

Like merger and acquisitions, strategic alliances are not easy arrangements to implement, as some recent studies demonstrate. According to Draulans et al., approximately 50 percent of alliances fail within four years,[4] and according to Hughes and Weiss the failure rate is about 70 percent.[5] Data are impressive, but it is also true that not all alliances actually fail. Some them are more simply terminated successfully by a mutual agreement between the parties because the common objectives have been reached.

These numbers raise two key questions: what makes an alliance successful? Why does an alliance fail?

A strategic alliance is a long-term agreement which regulates the relationships between two firms that want to cooperate and collaborate to improve their competitive position and performance by sharing resources.

Such an agreement defines the mutual commitments of both parties and the common objectives to reach in a certain period of time. From the corporate strategy perspective, strategic alliances can be used to exchange, share, or jointly develop products, services, and resources (tangible assets, intangible assets, organizational competences).

Unlike other scholars, we differentiate the concept of alliances from that of networks. The latter is an alliance between more than two firms aimed at competing against other similar groups or traditional single firms. Networks are also known as "constellations." A typical example regards the air transport industry, where various networks exist such as Sky Team and Star Alliance. Normally, networks are not necessary to enter a new business, but rather to reinforce a competitive advantage in one or more of the businesses in which partners are already present[6].

Strategic alliances can be classified by adopting various taxonomies. First, they can be distinguished by the contribution they make to the implementation of a portfolio strategy as follows:

- *Alliances to enter a new business* (an industry segment or geographic market). For example, in 2001, the well-known Bulgari group, that operates in the jewelry industry, stipulated an equity agreement with the Marriott group (more specifically, with the group's luxury division) to launch Bulgari Hotels & Resorts. Today, this company stands out as one of the leading luxury hospitality collections, with properties in Milan, London, Dubai, Bali, Beijing, and Paris, and two restaurants in Japan. Another example of this kind of alliance is represented by the distribution agreements that many medium-sized companies make to enter into one or more foreign markets through export policies.
- *Alliances to reach or strengthen a competitive advantage* in one or more of the businesses in which the firm has already invested. This is the case of the Fiat group (now FCA), that after being present in the commercial vehicles segment for a long time, in 1978 decided to create an equity joint venture with the French group PSA to benefit from economies of scale in product development and manufacturing that it would not have been able to achieve alone.

A second classification method divides alliances based on their main strategic motivations, with the result of identifying six types:

- *Law alliance*, whose motivation depends on the need to meet legal requirements. For instance, in some countries it is possible to operate only through a local partner (for example in Iran, currently, and in China in the recent past).
- *Link alliance*, whose motivation is to have access to resources that the firm does not possess or that are not easy and economically convenient to obtain. For example, a firm can decide to enter into an alliance to exploit the partner's after-sales services network, avoiding having to make this kind of investment alone.
- *Scale alliance*, whose motivation is to join forces with other firms that need to achieve minimum efficient scales in carrying out some value-chain activities or want to benefit from stronger economies of scale by pooling similar resources. The case of the FCA-PSA joint venture is an example of this type.
- *Geographical alliances*, whose motivation is to facilitate access to a new geographic market. In 2018, Starbucks Corporation announced a global coffee alliance with Nestlè S.A. to grow the global reach of Starbucks brands.
- *Learning alliance*, whose motivation is to learn from the partner in order to promote innovations in the company. For example, many agreements between pharmaceutical and biotech companies respond to this motivation. The pharmaceutical company can acquire new resources to master new therapeutic areas while the biotech company can raise financial resources to accelerate research and development activities otherwise not available (the collaboration relationship is thus a link alliance from the perspective of the biotech company).
- *Platform leadership alliances*, whose motivation is to obtain a market power advantage. In this case, it is important to avoid creating an obstacle to the free play of competitive forces by forming alliances restricting competition or establishing and abusing dominant positions. Otherwise, antitrust authorities will intervene by imposing fines on undertakings violating rules or acting to ensure a level playing field for all market's players.

Of course, when applying this classification, it can happen that the partners' motivations may not be the same within a specific agreement, and an alliance can pursue several motivations jointly.

A third classification distinguishes alliances into equity and non-equity alliances, as described in the Chapter 9. When an alliance is governed only by a contractual agreement, it is defined as a non-equity alliance. When a contractual agreement is supplemented with an equity holding in the alliance partner (a minority equity stake), with a cross equity holding (cross equity stakes), or with the creation of a legally independent firm in which both parties jointly invest to pursue the common goals (a joint-venture), it takes the name of equity alliance.[7]

Equity alliances provide specific advantages compared to non-equity alliances. Two of these are particularly relevant. First, they are more suited to deal with a high level of uncertainty regarding the future evolution of the collaborative relationship, which cannot be easily regulated in advance even with the most complex and articulated contractual agreements. Second, they increase the mutual trust (social capital) between the partners[8] and strengthen their commitment to collaborate over time. Hence, with an equity alliance it is more likely the parties will fulfill their contractual obligations, prolong the duration of alliances, limit opportunistic behavior, mitigate the harm produced by the learning race (this phenomenon will be briefly mentioned in next sections), and find mutually beneficial solutions in the event unexpected problems arise in managing the alliance.[9]

However, empirical evidence shows that even an equity participation does not completely eliminate the need to seize every opportunity to strengthen the trust between partners during all phases of an alliance cycle. Trust can be easily be called into question by “mixed messages, broken commitments, and unpredictable behavior from different segments of a partner organization.”[10]

Lastly, alliances can be differentiated based on the subject of the agreement. For example, in the automotive industry, where numerous cooperation relationships exist, they are classified as product development alliances (alliance between FCA and PSA in commercial vehicles), research and development alliances (alliance between FCA and Google for self-driving vehicles), manufacturing alliances (alliance between FCA and PSA in commercial vehicles), marketing alliances, or cross-border strategic alliances (alliance between FCA and GAC for the Chinese market).

11.2 The alliance process

The forming and implementation of a strategic alliance is a long process consisting of different phases, which we propose to logically separate into:[11]

1. Selecting a partner (origination).
2. Structuring the alliance.
3. Negotiating the agreement.
4. Managing the alliance.
5. Re-evaluating the alliance.

Each phase requires a different type of knowledge and information in order to have success, and generally sees the engagement of various managers working as a team (alliance team). In the more complex firms, these are managers of the business development unit working full-time to plan and form alliances (and M&A). Generally, business development units operate at the corporate headquarters and report directly to the group CEO. In firms with simpler organizations, alliance teams are formed with functional or business unit managers who are temporarily assigned to this project.

11.2.1 Phase 1: Selecting a partner

The first phase in creating a successful alliance is preceded by a process of careful strategic thinking to define the growth goals that the firm intends to pursue and the strategic resources gap that must be bridged by forming this kind of arrangement.

We observe that each firm develops its own vision and beliefs on the utility of alliances as a growth mode. For example, in the automotive industry, the conduct of the main players is not similar:

- Honda and Hyundai are not inclined to form alliances.
- BMW creates alliances regarding technological development, but is very reluctant to enter into product development alliances.

- Renault-Nissan and FCA have many alliances in place, of different types.

Those differences can be due to the fact that the corporate strategy of one company can have a greater need for alliances compared to that of another, or simply due to managerial choices that lead to preferring total control over all business activities (through internal development or M&A) instead of opting for collaboration with third parties. Differences in vision and believes bring leadership to incentivize alliances, or concentrate only on pathways to growth protecting the full independence of the firm.[12]

To select potential partners, firms carry out screening processes that can take place in three non-mutually exclusive ways:

- *Informal*, potential partners are selected by exploiting the network of personal relationships of managers (social capital).
- *Opportunistic*, a counterpart in a short-term collaboration or in a market transaction can become a potential partner in a strategic alliance.
- *Systematic*, potential partners are selected on the basis of criteria identified during the strategic thinking phase through a desk research process.

The first two options for screening are the most used in practice because they increase the likelihood of forming an alliance, since they set a positive tone from the start of the process and facilitate the building of a climate of trust. Through these options a firm can also reduce the risk of wasting time with potential partners who are not very interested or reliable once contacted.

In addition to being willing to form an alliance, the potential partner should first of all have strategic objectives compatible with those of the firm who wants to enter into the alliance. Secondly, the resources it can contribute to the alliance should match with those of the latter. Depending on the type of alliance, the matching can be achieved by combining similar or complementary resources. For example, in a scale alliance, the potential partner should have similar resources to exploit economies of scale, while in a link alliance it should have complementary resources.

The origination phase can last a number of weeks (for each potential alliance) and conclude with a business idea of the alliance, the selection of a potential partner, and the signing of a non-disclosure agreement to exchange sensitive information.[13]

11.2.2 Phase 2: Structuring the alliance

Phase 2 of the process is the first that requires a significant investment by the two partners and can last several months to be completed. It includes two main activities:

a) *The design of the business model,*[14] *organizational model, and governance model of the alliance*. This activity is carried out jointly by the partners who are interested in assessing the convenience and feasibility of the collaboration. In parallel and separately, each one of them will calculate the synergies they can obtain by implementing the agreement. This analysis leads to choosing whether to form an equity or a non-equity alliance.
b) *The negotiation and signing of a non-binding agreement* that lays the foundation of the alliance and allows for approving the shift to the phase of negotiation of the binding agreement.

In this phase, parties must verify the existence of two critical success factors:

- *A good strategic and organizational alignment or fit*. Such an alignment is achieved when partners (1) pursue strategic objectives which are complementary and non-conflicting, (2) carefully evaluate and recognize the similarities and differences in the partners' organizational structures; (3) share the same vision of the future developments within the industry in which the alliance will be created; (4) consider the alliance similarly important to implement their corporate strategy; (5) are able to detail alliance objectives that meet all partners' needs and expectations; and (6) define how alliance conflicts regarding strategic issues will be handled in the future.

- *A good relational and operational alignment or fit*. Such an alignment is obtained when it is possible to (1) integrate partners' cultures and skills; (2) find a balance of the partners' interests and power; (3) manage the tensions between collaboration and competition by building on a reciprocity norm; (4) design a context where communication is open and constructive; and (5) design an effective alliance scorecard to measure alliance performance against the expected goals.[15]

11.2.3 Phase 3: Negotiating the agreement

Phase 3 of the process consists of three activities:

a) *Conducting due diligence*, that in the case of alliances involves sharing and verifying a range of information allowing the two partners to assess its convenience in order to implement their corporate strategies. We note that the due diligence precedes, and does not follow, the definition of the binding offer, and regards only the functional areas directly involved in the alliance, not the whole firm.
b) *Drafting of the business plan*, which allows to financially and legally structure the deal.
c) *Negotiating the binding agreement*. The agreement contains the following main provisions: (1) the shared goals of the alliance; (2) the duration of the collaboration; (3) the performance measures to be monitored to assess the success of the collaboration; (4) the roles and responsibilities of the partners for the various activities provided for in the alliance; (5) the investments of the partners (financial resources, human capital, intellectual properties, etc.); (6) the governance model through which the alliance is managed, organized, and regulated; and (7) the procedures for conflict management and to modify or terminate the agreement.[16]

11.2.4 Phase 4: Managing the alliance

Once the agreement has been signed, phase 4 of the process begins. First, the two partners develop the organization necessary to manage the alliance and put the governance model into practice. Depending on the type of collaboration, startup activities can last either a few months (as in the case of distribution alliances) or a longer period of time (as in product development or production alliances). Second, they have to start and keep alive four processes that are critical for allowing the alliance to thrive:[17]

- *Coordination,* clear division of responsibilities and effective management of operating processes and interdependencies within the context of the alliance and between partners.
- *Communication,* establishment of processes and policies to formally and informally share valuable information in the context of the alliance and between partners.
- *Emotional involvement,* development of personal relationships between the managers of the two partners (generally, emotional involvement of managers within the alliance is easier to achieve, given their direct commitment).
- *Learning,* codification and sharing of new knowledge, capture and dissemination of good practices and lessons learned both within the alliance's organization and for the benefit of the alliance partners.

Reaching a high level of effectiveness in these four processes encourages people to work together, avoids opportunistic behavior, keeps the partners' commitment high over time, and builds trust that is a key ingredient for the alliance's success.

The alliance teams of the two partners are always involved in the management of the alliance. If the alliance provides for the establishment of a new legal entity, such as in joint ventures, its management team becomes the third significant actor to consider and properly involve.[18]

11.2.5 Phase 5: Re-evaluating the alliance

The last phase of the alliance process can take place either at fixed points in time set by the agreement signed in Phase 3, or on request from one or both of the partners. After a re-evaluation, the partners can decide to continue the alliance according to the business plan and the agreements, to continue the alliance by modifying one or more elements, or to terminate the alliance.

The exit, if agreed upon by the parties, cannot always be considered a failure: it can be the natural conclusion of the alliance's life cycle.

However, each of the two partners must carefully assess the moment at which to terminate the agreement, because ending it too early can preclude the complete exploitation of the advantages provided by the alliance. In any event, the exit makes it necessary to tackle new questions: to continue independently in a business or not, to find new partners, or to exit that business?

11.3 The reasons for failure of a strategic alliance

Alliances can fail for different reasons. Given that there is a subtle but important difference between an agreed-upon ending and the failure of an alliance, as already mentioned, it is possible to summarize the common reasons for failure as follows:

- *Strategic misalignment*. If the strategic objectives of the alliance partners are not consistent with each other or are fully incompatible, the risk of selecting the wrong partner will increase. This type of mistake usually translates into conflicts during the management phase, which can jeopardize the continuation of the collaboration, unless one of the two partners is willing to modify its strategy.
- *Inaccuracy in the contractual agreement or unclear provisions and terms*. In some cases, the agreement is not drafted with the proper accuracy or the terms and provisions are not clear enough, or are incomplete, with the effect of generating misunderstandings, tensions, and conflicts.
- *Opportunistic behavior in the form of adverse selection cheating, moral hazard cheating, and hold-up cheating*. Adverse selection exists when an alliance partner misrepresents the resources they can bring to an alliance. Moral hazard exists when an alliance partner controls the resources it declared it controls, but it does not contribute them to the alliance.[19] Hold-up cheating exists when one partner exploits the

transaction-specific investment made by the other partner. If these opportunist behaviors emerge, the trusting relationship will be harmed. Only through a deep revision of the alliance could trust be restored. But these are rare cases.

- *Learning race*. Learning race between partners occurs when they both try to internalize their partner's unique complementary resources through the alliance and then terminate it to avoid sharing the benefits of the integrated knowledge.[20] A learning race can take place even simply because one of the partners is faster than the other in its learning processes, with the result that the slower partner feels expropriated and questions the continuity of the alliance. In this case as well, it is very difficult to restore an alliance once this conduct has been discovered.
- *Difficulty of cultural integration*. Despite the absence of a deliberate intention to undermine the collaborative relationships (as in the case of opportunistic behavior and the learning race), an alliance may not reach its goals simply because during phase 4, the two partners recognize a substantial cultural incompatibility. In this case, it is particularly difficult to continue the alliance.
- *Ineffective governance*. In some cases, the two partners start the alliance with the best intentions, but they make mistakes in designing the governance that does not promote efficient decision-making, does not support the overall goals of the alliance, and does not protect the specific investments of both partners. Sometimes the governance can be well-designed in the beginning of the alliance cycle, but then the partners do not pay enough attention to evolving it as the alliance grows in scope.
- *Poor leadership or bad choice of the team dedicated to the alliance*. In some cases, the alliance could represent a valid strategic option and the partners are genuinely interested in its execution, but one of the partners (or both) do not place the right people in the alliance team or do not appoint the right executives or managers in joint ventures. Not all people are suitable to be involved in cooperative strategy because their attitude, motivation, or skills do not fit with this job.[21] In this case, the alliance could continue, on the condition that the governance is modified.

- *Evolution of partners' commitment*. The partners' commitment to the alliance could decrease or even derail over time because their corporate strategy naturally evolves to seize new opportunities or react to sudden threats. As a result, an alliance could naturally become useless or harmful over the years. In these cases, it is difficult for the alliance to continue, and a good agreement stipulated in phase 3 can allow for an orderly exit.

11.4 The development of an alliance competence

One of the hurdles to alliance success lies in the lack of adequate alliance competences, understood here as organizational abilities for finding, developing, and managing alliances. The lack of these competences, in a sense, is quite natural because the firms that have formed a high number of alliances in their history are relatively rare. Furthermore, the alliances made by a firm over the years can be very different from each other, making it difficult to carry out learning processes as already argued in the previous chapter when analyzing the M&A process.

To develop such competences, successful firms create alliance teams equipped with people with previous experience in the field and develop capable and well-trained alliance managers, who are responsible for negotiating, structuring, and running an alliance. These teams have cross-functional skills and operate across the organization mainly through lateral relationships,[22] while alliance managers are pivotal in proposing changes in the alliance agreement and following the process of learning based on the codification of knowledge and good practices through:[23]

- The preparation of a manual with the lessons learned on how to implement the various phases of the alliance process.
- The drafting of one or more cases of success or failure based on previous experiences.
- The design of training programs to develop skills in forming and managing alliances in all executives and managers who can potentially be involved in this initiative.

Concerning the relationships between prior alliance experiences and alliance success, it is worth noting that a recent study raises some doubts regarding the usefulness of codified knowledge, at least for some phases of the process:

> We find that in the partner selection and termination phases, reliance on codified knowledge is useful. However, in the partner management phase, reliance on codified knowledge is less beneficial and can be even negatively related to performance. […] High performing firms may require multiple solutions that support both more and less structure.[24]

For an effective management of alliances, it thus seems necessary to plan actions based not so much on codified knowledge, but on the firm's culture and on tacit knowledge developed by the alliance teams. In the case of FCA, for example, the team (named the "business development" team) consists of about ten people for only the EMEA Region (Europe, Middle East, and Africa), some of whom have worked there for many, many years.[25] And many of them have been able to develop particular attitudes and skills that seem very useful to interact with the partners, which can be summed up as follows:[26]

- A strong orientation towards the future, which helps to maintain clarity regarding the long-term advantages of an alliance even if it is well known that alliances are marriages of convenience.
- The ability to place the same emphasis both on finding compromise and on exploiting a strong bargaining position in negotiating and managing the relationship with the partner to build mutual trust and a fair balance of power and interests.
- The ability to manage the tensions between collaboration and competition which typically emerge in the management phase.[27]
- The ability to resist against potential negative events (resilience) and to exploit potential positive events (proactivity) in the context of an alliance.

In looking at this list of abilities and skills, it is easy to identify some similarities between the job of alliance teams and that of diplomats. In diplomacy, each country must be able to simultaneously manage relationships in an alliance and rivalries with other partner countries.

Remaining in the field of management, a very interesting study published some years ago by two famous scholars, found that alliance teams contribute to the success of a cooperative relationship if they are able to:

- Focus less on defining the business plan and more on how a firm and its partners will work together.
- Develop metrics pegged not only to alliance goals but also to performance in working toward them: information sharing between the partners, the development of new ideas, the speed of decision making.
- Instead of trying to eliminate differences, leverage them to create value.
- Go beyond formal systems and structures to enable and encourage collaborative behavior.
- Be as diligent in managing internal stakeholders as in managing the relationship with partners.[28]

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[1] *The Economist* (2015). To avoid believing that the phenomenon of alliances is recent, it is worth noting that a well-known Italian business economist, in studying the transformation underway in the economies of industrialized countries, pointed out the growing importance of various types of agreements already in 2000: see Cavalieri (2000).

[2] The risk that collaboration between two companies excessively limits their independence had already been noted in Ferrero (1968), par. 27.

[3] The search for management on the subject of alliances is also growing in number and quality: see Wang and Rajagopalan (2015).

[4] Draulans, deMan and Volberda (2003).

[5] Hughes and Weiss (2007).

[6] Many of the reflections that follow on alliances are true for networks as well, with the appropriate adaptations.

[7] For further discussions on growth mode, see Chapter 9.

[8] Mutual trust is intended as "your willingness to be vulnerable to a partner's actions based on a belief that the partner will not harm you;" Puranam and Vanneste (2016), pp. 268-269.

[9] Zollo, Reur and Singh (2002).

[10] Hughes and Weiss (2007).

[11] Puranam and Vanneste propose a different classification of the phases: selection of a partner, due diligence, evaluation and negotiation, implementation, and evaluation (renewal or exit); see Puranam and Vanneste (2016), Chapter 12.

[12] In Chapter 9, we discussed two frameworks to select the best mode of growth on the base of the growth strategy and the strategic resource gap to fill.

[13] A non-disclosure agreement – also known as a confidentiality or secrecy agreement – is a legal instrument that designates confidential information, by which the parties undertake to keep that information secret, on penalty of breach of the agreement and thus triggering specific clauses contained in the same.

[14] "A business model consists of four interlocking elements that, taken together, create and deliver value […]: Customer value proposition, Profit formula, Key resources and Key Processes": Johnson, Christensen and Kagermann (2008), pp. 60-61.

[15] See Ireland, Hitt and Vaidyanath (2002).

[16] Puranam and Vanneste cite five important elements of an agreement: task division ("What needs to be done"), task allocation ("Who does what"), value sharing ("Who gets what"), interface ("Who talks to whom"), and dispute resolution ("Who is the tie-breaker"): Puranam and Vanneste (2016), pp. 271-272.

[17] See Ireland, Hitt and Vaidyanath (2002).

[18] As we will see below, in Section 11.4, it could be useful to distinguish the teams dedicated to the strategic alliances within the two partner companies, if those teams exist, from the other managers.

[19] Barney and Hansen (1995), Williamson (1975).

[20] Hamel (1991).

[21] See Donna (1992), p. 72.

[22] "A dedicated alliance function is usually effective at promoting alliance stability and success": Ireland, Hitt and Vaidyanath (2002).

[23] In essence, this means applying some principles of *knowledge management*: see Nonaka and Takeuchi (1995).

[24] Heimeriks, Bingham and Laamanen (2014).

[25] The team deals with all the operations that involve an external partner, and thus both alliances and M&A.

[26] Remarks by Mrs. Silvia Vernetti, Head of EMEA business development FCA, to the students of the Bocconi University, March 14, 2017.

[27] To define this attitude, the terms *frenemies* and *co-opetition* have been coined.

[28] Hughes and Weiss (2007).

12 The Entry in International Markets

by *Gabriella Lojacono**

12.1 Corporate scope and geographic context

Corporate strategy decisions that regard a change in corporate scope, affecting the degree of internationalization,[1] have specific managerial implications for multibusiness firms. In these situations, the leadership needs to make a series of important decisions: which country to begin producing/selling in, the type of ownership structure for foreign investments or the entry mode into a country,[2] the activities to be carried out in foreign countries, the degree of autonomy to be given to overseas branches, and the design of the relationship between corporate headquarters and the foreign branches.

12.2 Globalization: drivers, opportunities, and threats

Globalization refers to the integration of individual national economies into one large single global market. The phenomenon was celebrated by Thomas Friedman in his 2005 book *The World Is Flat*.[3] The work asserts that the differences between countries are vanishing as geopolitical barriers are being broken down. Friedman presents globalization as an irreversible phenomenon which is driven by five factors:

- *The removal of administrative barriers* due to the creation of free trade areas and the promotion of Foreign Direct Investment (FDI).

- *The evolution of Information and Communication Technology* (ICT) and the reduction in its costs. This has allowed companies, for example, to create a network of geographically dispersed subsidiaries and benefit from the spread of online selling and social media.
- *Emergence of new technologies* (such as Industry 4.0, 3D printing and robotization), that could modify the configuration of the supply chain and the comparative advantages of nations.
- *Advances in logistics,* which allow goods and people to move around quickly and cheaply.
- *The convergence of tastes and habits* among people who are most exposed to other cultures through global media (from Facebook to MTV). The phrase "one-size-fits-all" aptly described the global standardization of consumer preferences, which opens up intriguing opportunities for firms, such as the possibility to produce and sell the same product or service regardless of the target country, benefitting from economies of scale.

This march towards integration resulted in the so-called "Connected Economy," which is visible in two key indicators: from 1980 to 2018, FDI stock in target countries increased by a CAGR of 10.7% and global exports by a CAGR of 6.5% both far outstripping the rise of GDP.[4] The rise of FDI is driven by a wave of mergers and acquisitions that increasingly involve foreign targets (known as cross-border M&As).

So it seems that globalization is a source of interesting opportunities for companies, in areas such as the reduction of costs, the increase of sales, and the expansion of the M&A market.

However, globalization also entails doing battle on the home front with aggressive overseas competitors. Take the example of the U.S. clothing market: 76.5 percent of its imports come from Asia (Fortune, 2011). As a consequence, the increase in competition provoked by globalization can expose unsuitable local business models and even lead to major corporate crises. Consider what happened to Benetton when the Inditex group (Zara, Bershka, Stradivarius, Oysho, Pull&Bear, and Massimo Dutti) and other fast fashion retailers arrived in Italy. However, even these competitors cannot "rest on their laurels" given the ever-increasing pace of competitive dynamics and the sudden emergence of new players on the international scene. Think of Uniqlo, the Japanese fast retailing group, and the Irish group Primark. Both of them needed just ten years to acquire more customers than retail giant Inditex in the latter's home country of Spain.[5]

The competition triggered by globalization has also helped to consolidate many industries. By way of example, we could mention cement, now dominated by LafargeHolcim; beer, where the market leader AB InBev recently took over SABMiller, the world's second largest group; and household appliances, where about twenty large groups have taken the place of approximately 120 players. Among these, two Chinese companies stand out: Haier, named by BCG as one of the world's most innovative companies, and Midea.

We need only to consult the Interbrand ranking, based on brand equity, and the Fortune Global 500 to understand that the so-called dragon multinationals (multinationals from emerging countries) are now the undisputed main players on the world stage. Sinopec Group and China National Petroleum (both based in Beijing) are the world's second and fourth largest companies by revenue respectively. Multinationals in emerging countries are growing three times faster than their counterparts in mature markets (CAGR of 13 percent vs. 4 percent from 2009-2014). Of the 100 most important players from emerging countries, 38 are of Chinese origin – including Xiaomi, the largest producer of cell phones in China –, while 16 are Indian. Their superior financial performance has also been reflected in stock market trends.[6]

Another consequence of globalization is the geographic concentration of certain activities in specific areas. This exposes international supply chains to the risk that production may be halted if an unexpected incident occurs. For example, China has developed manufacturing geographic clusters with specialized subcontracting networks. Apple has outsourced certain manufacturing phases to China, not so much for cost advantages (labor costs represent a tiny fraction of the total production cost), but due to the presence of companies like Foxconn, which have gradually acquired distinctive competence in the production of certain components and in product assembly.

12.3 The world is not flat

McDonald's serves vegetarian hamburgers in India and spicy burgers in Mexico. Coca-Cola uses different types and quantities of sugar in its secret formula depending on the target country. MTV's Indonesian programming now includes a call for prayer five times a day. These are just a few examples of well-known companies which have chosen to adapt their products or services based on the specific characteristics of foreign markets.

Many firms have found it very difficult to succeed in certain countries because of specific local needs, such as Google in Russia, Uber in China, Illy in North America, The Walt Disney Company in France, Sephora in Japan, and Zara in Germany. Such difficulties led some firms to eventually abandon the foreign markets where they had invested: this was the case of L'Oréal group, whose Revlon and Garnier brands were withdrawn from the Chinese market in 2015 after misjudging the strength of their product portfolio and the replicability of their sales strategies.

Barriers to entry in a foreign market are not just cultural, as we will see later. Ikea waited many years before entering the Indian market in 2016, and even then it had to make concessions to the Indian government, which forced it to operate through a joint venture and to obtain at least 30 percent of its supplies from local small and medium-sized enterprises.

The differences between countries mean that globalization is an unfinished process, unlike what Friedman claimed. As noted by Pankaj Ghemawat, we live in a semi-globalized world, a *World 3.0*, not a globalized world, a *World 2.0.* For example, it is true that the cost of international telephone calls has dropped significantly, but fewer than 10 percent of calls go across national borders. Or it is said that Italian universities are now full of foreign students, but they actually make up less than 10 percent of the total student population.

Many indicators show that "actual levels of internationalization across all these different types of markets fall very short of the levels implied by World 2.0."[7]

Given that distances and borders between countries still play an important role, many studies have shown that firms doing business abroad have a lower operating profit compared to their local competitors and their performance on the domestic market. Although Starbucks' profitability has risen on the whole in step with its increased international exposure, it has an average performance differential of approximately 30 percent between the United States and other countries. Despite spending 12 billion dollars on 36 overseas acquisitions, Cemex continues to earn much more in Mexico (its home market) than in any other country, while Walmart is most profitable in the United States and the other markets belonging to the NAFTA area (Mexico and Canada).

As companies attempt to grow internationally, they suffer from what the literature calls the Liability of Foreignness (LoF). The LoF has three main causes:[8]

1. The unfamiliarity with the local context, requiring time and money to adapt to the new conditions.
2. A lack of consolidated relationships with the local network and of processes within the newly established branches.
3. Potential discriminatory actions by governments (e.g., subsidies which only local firms can access).

L'Oréal, for example, has always had a very low market share in South Korea compared to local competitors such as Amore Pacific for the reasons mentioned above. First of all, it never had a suitable product range for such a specific market (skin care for women in Korea involves from five to eleven sequential treatments). Second, the country's cosmetic association promoted a campaign encouraging the use of local cosmetics products instead of those coming from abroad. Third, taxes and duties on imports were very high for foreign companies such as L'Oréal. Lastly, L'Oréal persisted with traditional distribution methods, while in South Korea cosmetic products are mostly sold door-to-door.

12.4 Analyzing differences between countries

The C.A.G.E. framework offers a systematic overview of the potential factors which create "distance" between countries. Such distances are influenced by *Cultural*, *Administrative*, *Geographic* and *Economic* aspects. The wider the distances, the greater the LoF. Table 12.1 summarizes the main C.A.G.E. distance factors.

Table 12.1 The C.A.G.E. distance factors

C	A	G	E
• Language differences • Ethnic differences • Religious differences • Differences in social norms	• Lack of colonial links • Lack of shared currency • Lack of political links • Political hostility • Differences in legal systems • Differences in trade policies • Institutional weakness	• Physical distance • Lack of common borders • Lack of access to sea • Size of country • Climate differences	• GDP and GDP per capita differences • Differences in availability, cost, and quality of human, financial, and natural resources; • Differences in infrastructure • Differences in distribution structures

Source: developed by author based on P. Ghemawat, "Distance Still Matters. The Hard Reality of Global Expansion," *Harvard Business Review*, September 2001, p. 140.

Ghemawat observes that as the C.A.G.E. distance between the country of origin and the target country falls, the export volumes and profitability that a firm can achieve in the target market rise. Similarly, a firm that invests abroad (e.g. by launching a new production unit or buying another firm) will run into fewer obstacles if it allocates its resources to countries with which it shares strong C.A.G.E. similarities.[9]

The importance of the C.A.G.E. factors varies depending on the industry in question (Table 12.2). An olive oil producer, for example, should consider the culinary traditions of foreign countries in question, in addition to the geographic distances and any weather conditions that could affect the product's organoleptic properties, at the time he chooses the geographic markets to prioritize.

Table 12.2 Industry/ goods affected by various C.A.G.E. distance: examples

C	A	G	E
• Publishing	• Oil	• Cement • Chemical	• Automotive • Home appliance

• Food & beverage	• Construction/ infrastructure		

Source: developed by author based on P. Ghemawat, "Distance Still Matters. The Hard Reality of Global Expansion," *Harvard Business Review*, September 2001, p. 140.

To summarize, the importance of differences between countries is precisely what makes the issue of selecting foreign markets even more critical. Firms often consider only one dimension of the choice, namely the economic attractiveness of the potential market, but in doing so they underestimate the risks and costs linked to a lack of understanding of entry barriers and the need to adapt to local quirks.

12.5 The motives for international expansion

The motives that lead firms to internationalize, i.e., to grow by related expansion through geographic adjacencies, can be classified into six categories:[10]

1. *The growth imperative*. In the 1990s, many Italian companies decided to go abroad when faced with the recession in Italy. Turning to foreign customers was considered the only way to maintain (or increase) sales volumes and maximize production capacity. Being a firm with international exposure also has the added benefit of attracting talent who can make an important contribution when it comes to innovation.
2. *The efficiency imperative*. This imperative comes into play when the minimum efficient scale for a firm to compete is greater than the size of the local market. Efficiency can also drive firms to look for cost advantages in their factors of production in order to be more competitive on the international stage. This was the case with Natuzzi, an Italian company that decided to set up manufacturing facilities in China to cope with the fierce competition of low-cost countries in the Unites States (its main market).
3. *The knowledge imperative*. Firms also go abroad to benefit from valuable resources such as technology and highly specialized human skills. The international scenario can be very different from the domestic situation, and that requires the ability to analyze and adapt.

Undertaking a gradual process of internationalization with the right commitment and a medium to long-term approach allows firms to develop internationalization know-how. For example, firms can devise their own methodology to select foreign markets, using the most suitable criteria for their particular business model. Although every country is different, and therefore some knowledge is required in each case, other aspects of a company's know-how can be leveraged in regions where countries are similar according to the C.A.G.E. framework.[11] Lastly, international expansion can allow the acquisition of valuable resources to enter new businesses. In fact, certain resources are located only in specific geographic clusters, such as Silicon Valley or Israel for technologies, or France and Italy for the production of luxury goods.

4. *The globalization of customers*. The internationalization of customers can be a powerful incentive to increase international exposure. In B2B industries, firms that expand abroad want to consolidate their supplier base and have partners who follow them all over the world, rather than having to find local interlocutors every time. If suppliers cannot satisfy this demand, they risk being replaced with global suppliers. This is why Almax, a manufacturer of mannequins for the clothing industry, decided to open a factory in Shanghai in 2008 to support its clients' retail growth in Asia.
5. *The globalization of competitors*. If its competitors in the industry operate globally, a company that still has a domestic scope will find it impossible to exploit global economies of scale, with the effect of losing competitiveness. In addition, its global competitors can use their multi-country presence to support one market using the resources generated in another.
6. *Risk management*. From a financial standpoint, a company can reduce its risk by carefully developing its portfolio of markets to cover different economic trends. Nevertheless, certain sources of risk cannot be easily mitigated through diversification, and instead need to be eliminated using suitable hedging instruments (e.g. exchange rate risk).

When analyzing the attractiveness of foreign markets, a company should start with the reasons behind its desire to expand internationally. There is a difference between seeking out sales opportunities (known as "market seeking" strategies), looking for skills and factors of production that are lacking ("resource seeking"), and attempting to reduce costs ("efficiency seeking").

12.6 The selection of foreign markets

The analysis of motives for international expansion is the starting point to understand whether internationalization offers any opportunities. Once this analysis gives a positive result, the firm has to select the specific geographic markets in which to invest on the base of their attractiveness. This choice should consider two factors:

- The strategic importance of the market for the firm.
- The possibility to capitalize on the market's potential.

12.6.1 The strategic importance of the market

To assess the importance of a geographic market, it is useful to consider both the economic variables of the target country (GDP and GDP growth, per capita GDP and income, etc.), and the current and potential per capita spending (or other indicators of market potential) for a given product and service in the target country. For example, Cemex chose Spain because its property market was expected to grow robustly in the 1990s; it was also easy to begin supplying other European markets from there.

The importance of the market also depends on the goals the firm sets for itself. For example, if the intent were to rapidly acquire/develop the competences necessary to enter into new businesses or geographic markets, it would be useful to evaluate the quality of the work force and the presence of specialist industries, research centers, universities, patents, and so forth. This explains why Haier realized that if it wanted to stand out among the crowd of Chinese appliance manufacturers and learn how to make high-quality and technologically-advanced products, it would have to produce them in the United States rather than in China.[12] In order to enter the perfume industry, Shiseido decided to open a branch in France, since the Japanese are not big producers and consumers of this type of products.

Then, a market may be even more or less attractive depending on the CAGE distance. In particular, a large administrative and economic distance (regulations, payment practices, exchange rates, currency risk, political stability, trade policies, characteristics of competitors and their offers, and competitive pressure) can make the target market less attractive than an initial analysis of the economic and learning possibilities may have indicated.[13]

12.6.2 The possibility to capitalize on the market's potential

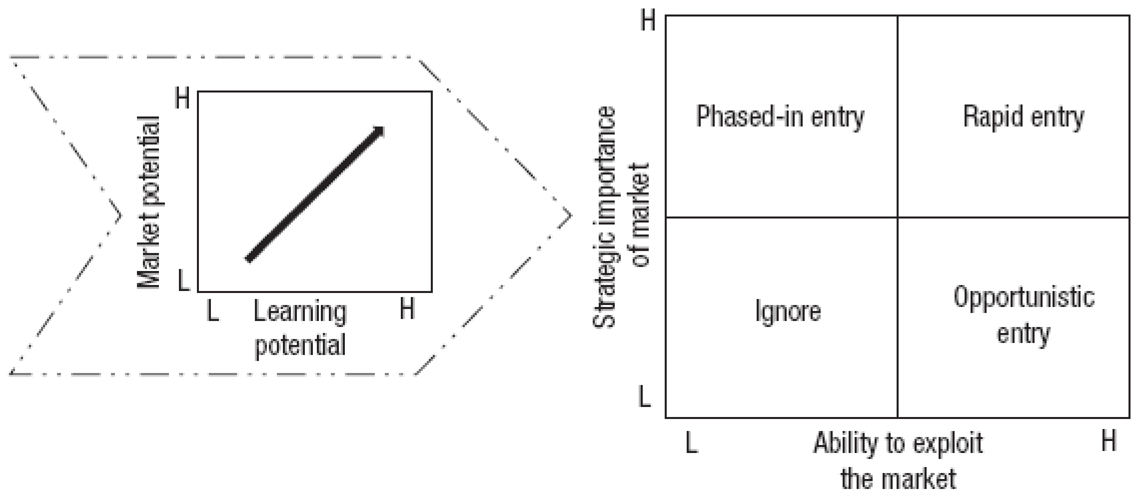
Even when the initial signs are auspicious and the target market seems to be the perfect location, internal barriers can still prevent a company from seizing business opportunities.

- *Functional barriers*, limited time for entrepreneurs and managers to handle international operations, existing skill sets unsuitable for dealing with the complexity of foreign markets, lack of financial resources.
- *Information barrier*, lack of accurate information relating to very peculiar markets. In the absence of a suitable analysis, a company risks relying solely on intuition and temporary opportunities (e.g. overseas orders) without following a medium to long-term vision.
- *Marketing barriers*, high C.A.G.E. distance factors mean a company must adapt its product, packaging, services, pricing, distribution and logistics. Among other things, it is important to assess how modifying pricing policies impacts product positioning as well as the increased transport costs and delivery times (with the consequent stock-out risk) caused by geographical distance.[14]

12.6.3 A framework for choosing foreign markets

The intersection between the two variables aforementioned – the strategic importance of the market for the firm, and the possibility to capitalize on the market's potential – determines the attractiveness of the foreign market and suggests potential entry strategies (Figure 12.1).

Figure 12.1 A framework for choosing foreign markets: drivers of attractiveness



Source: developed by author based on A.K. Gupta, V. Govindarajan, "Managing Global Expansion: A Conceptual Framework," *Business Horizons*, March-April, 2000, p. 48.

When the market is very appealing, but progress would be hindered by major internal obstacles (top-left quadrant), it is best to wait for the company to develop the necessary knowledge of how the country operates. In these cases, it is advisable to enter a market which resembles the target market but is less complex. This gradually prepares the company for entry into the target country. For example, Canada could act as a temporary substitute for the United States, or Austria for Germany.The opportunistic entry shown in Figure 12.1 (bottom-right quadrant) refers to the possibility of a company generating sporadic revenue abroad without ever consolidating its presence on the foreign market in question. If the situation is as shown in the top-right quadrant, we suggest entering the target market without hesitation, while companies should avoid entering a country that falls in the bottom-left quadrant.

Having assessed the foreign market in terms of attractiveness, a company can check if it will be able to generate a competitive advantage and a corporate advantage there. The questions to be asked are similar to those used when entering a new industry: will the available corporate resources be effective in other countries, or do local businesses have better resources to compete in their own countries? Is it possible to transfer or share resources between countries?

12.7 Entry modes

After the firm has selected the country (or countries) and crafted a suitable adaptation strategy, it must determine how to enter that country: the foreign market entry mode (or simply "entry mode"). Often, managers are not free to choose their own entry mode. Instead, they have to respect a *diktat* imposed by the host country.

The empirical results of a study carries out by Pan and Tse on 10,000 entries into the Chinese market show that when selecting their entry mode, foreign firms first of all choose whether or not to invest equity in their overseas venture.[15] We can therefore image a continuum of capital investment ranging from 0 to 100 percent (i.e., full control over the activities abroad). A company's willingness to increase its financial commitment in equity depends on commercial and political relations between the target country and the country where the company is headquartered, as well as a number of elements regarding the foreign market (e.g. risk level) and the top management (e.g. risk propensity).

According to the model proposed by Pan and Tse, the modes of entry into a new country can be classified into two groups: equity entry mode and non-equity entry mode. The first group includes:

- *Wholly owned subsidiary*, both greenfield and mergers and acquisitions.[16] A greenfield investment is the best alternative if the local market is growing and the company has valuable resources that it wishes to protect. This alternative gives the company the freedom to shape the culture, systems, and processes of its new branch in line with the identity of its corporate headquarters. However, it takes longer than mergers and acquisitions, which have the benefit of rapidly increasing a company's market power and driving important operational synergies.

- *Minority equity stake.* This is an alliance with a minority participation in the equity of a foreign company. Often, these are equity alliances contracted with distributors operating in the target market.
- *Joint venture*, that can be majority, minority, or equal ownership. Joint ventures have the unquestioned advantage of overcoming the liability of foreignness thanks to the know-how provided by local partners, and they also reduce the financial commitment. However, there is a risk that the participants will be culturally incompatible or will have contrasting objectives.[17]

The non-equity modes of entry include direct and indirect export policies, and contractual agreements (franchising, licensing, turnkey projects, and co-marketing and joint R&D agreements).

Given that joint ventures and contractual agreements fall into the category that the literature calls "strategic alliances," they are more suitable than wholly owned subsidiaries under the following conditions:

- The C.A.G.E. distance between the country of origin and target country is vast.
- The foreign branch would not be integrated with the rest of the multinational group from an operational standpoint.
- There is a low risk of "asymmetric learning" or a "learning race."[18]
- The firm has limited financial resources to invest in the internationalization project.

The literature claims that moving from exports to JV agreements to wholly owned subsidiaries gradually increases a company's control over its international operations, and its commitment toward its overseas arm, but it also ups the degree of risk. In reality, however, there are cases where exporters have demonstrated a high level of commitment that has been rewarded by good competitive and financial performance. One example is Pasta Zara, which exports 92 percent of its products to 108 countries. It is Italy's largest exporter of pasta and the country's second largest producer overall. The company began to expand internationally in 1975 by exporting to Austria, Germany, and Greece, and it quickly became a point of reference in private label agreements with major global chains. Barilla, the giant competitor in this industry, has 30 factories of which 16 are abroad. This goes to show that even in the same industry, companies choose different countries and entry modes.

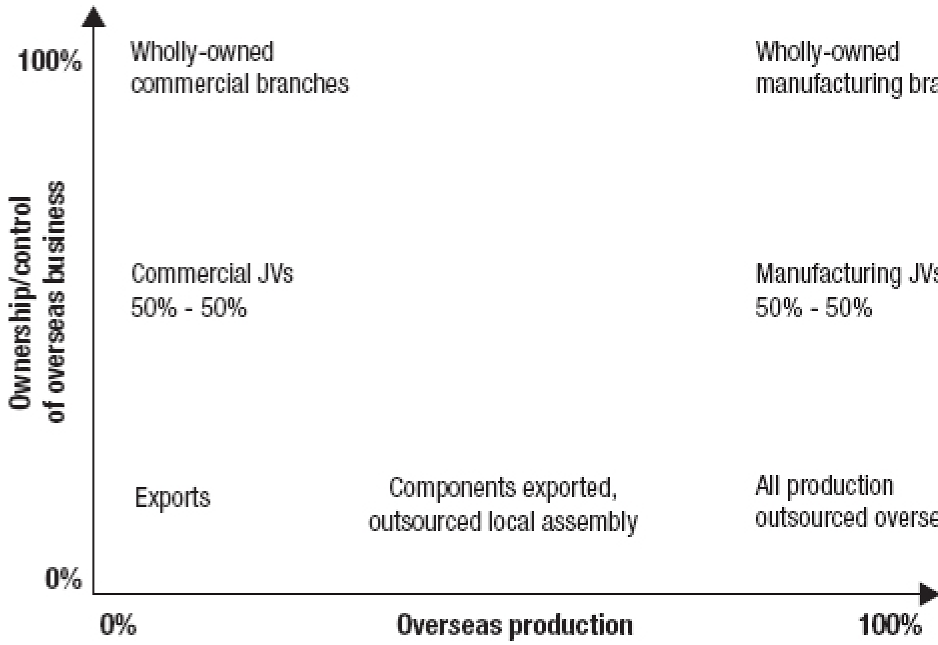
The entry modes must be seen dynamically: firms can use different methods depending on the country, and at the same time, can modify their presence in any given country shifting from indirect exports to commercial and manufacturing branches.[19] Starbucks, for example, has combined joint ventures (in Japan) with organic growth (in Canada) and acquisitions (in the United Kingdom). Joint ventures were useful to Starbucks as they allowed the company to enter into franchise agreements with local entrepreneurs.

Any study of entry modes would be incomplete without considering a second dimension: the type of activity to carry out in the target market. A firm has the option of exporting everything produced in the domestic market, exporting semi-finished products to be assembled on site, or producing 100 percent of its products in the foreign country.

Figure 12.2 combines the two dimensions cited above:

- The degree of ownership/control: absent in the case of contractual agreements or 100 percent for greenfield and acquisitions.
- The scope of the activities carried out abroad: absent for export or 100 percent for overseas production.

Figure 12.2 **Entry modes: proprietary control and activities carried out abroad**



Source: developed by author based on A.K. Gupta, V. Govindarajan, "Managing Global Expansion: A Conceptual Framework," *Business Horizons*, March-April, 2000, p. 49.

There are multiple reasons that lead to producing in the target country. For example, the size of the local market (which must be larger than the minimum efficient scale); the transport costs in relation to the value of the goods; needs of geographic proximity or local adaptation; or regulations that burden the products with standards to be followed and heavy duties to be paid. Choosing the correct mode is of a great importance to any firm: once it has invested in a certain direction, it is often complex and expensive to turn back. Just like any strategic choice, these decisions are difficult to reverse.

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[1] For an explanation of the concept of corporate scope, see Chapter 6.

[2] For discussion of modes of growth, see Chapter 9.

[3] Friedman (2005).

[4] Source: OECD, UNCTAD, World Bank.

[5] Oppes (2016).

[6] Kynge (2016).

[7] Ghemawat (2011), p. 31.

[8] Hymer (1976); Mezias and Luo (2002); Zaheer (1995).

[9] For example, two countries that share the same language have a trade volume 42 percent higher than countries where different languages are spoken. This percentage rises to +114 percent in the case of the same currency. See Ghemawat and Mallick (2003).

[10] Gupta and Govindarajan (2000).

[11] The aggregation of countries based on CAGE is part of Ghemawat's Triple A Framework, along with adaptation and arbitrage. The author argues that internationalization choices offer corporate headquarters a trade-off, since the differences between countries are a source of both advantages and disadvantages. While on the one hand they require companies to bear the cost of adapting to local quirks, on the other they allow companies to benefit from arbitrage and aggregation policies. See also Meyer, Mudambi and Narula (2011).

[12] The literature uses the term "catch up strategy" to describe the process by which companies from emerging countries decide not to seize the cost-reduction opportunities available in their own countries and instead invest in developed economies.

[13] Information on macroeconomic variables of different countries can be found in international databases such as the World Trade Organization (WTO), UNCTAD, International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), and World Bank. The latter issues an annual report called the *Ease of Doing Business*, which ranks countries around the world based on features of their legal and tax systems, investment protection, insolvency resolution, trade policy, etc.

[14] A Zara T-shirt is 25 percent more expensive in Italy and 100 percent more expensive in Japan compared to its price in Spain. Zara therefore competes in a different market segment here.

[15] Pan and Tse (2000).

[16] For further discussion on modes of growth, see Chapter 9.

[17] According to Buckley and Casson (1988), joint ventures can be configured as: forward integration joint venture, with investments in downstream activities in the value system; backward integration joint venture, with investments in upstream activities; buyback joint venture, in which the two partners jointly carry out the same activity in the value system to increase their market power and allow for economies of scale; multistage joint ventures, that offer the possibility for one partner to integrate downstream and for the other to integrate upstream.

[18] For discussion of the phenomenon of the learning race see Chapter 11.

[19] Root (1994).

13 Ownership and Corporate Governance

by *Alessandro Minichilli*[*] and *Fabio Quarato*[**]

13.1 The relevance of corporate governance

In this Chapter, the issue of corporate governance will be introduced from a broader perspective than how it is generally treated in traditional Anglo-Saxon literature, most of which tends to concentrate the debate on the role of the Board of Directors and the supremacy of public companies. This approach is consistent with many factors that have challenged the uncontested domination of the capitalist model of widespread shareholding (the so-called *public company*), which has been considered by many to be the natural evolution of any entrepreneurial initiative:

- Over recent decades there has been an increase in the dominance of large institutional investors who, especially in English-speaking countries, now hold about 70 percent of share values on the capital markets.
- The regulations introduced after serious corporate scandals (such as Enron and Parmalat) and the financial crisis of 2007 weakened the public company model and imposed additional listing costs for companies that decide to go public in a regulated market.
- The rethinking and reinvention of ways of doing business along with the spread of many high-growth startups have deemphasized the importance of public companies as a growth engine for the economy. High-growth startups have low capital requirements (often met by seed

capital platforms such as SeedInvest) and are based on technologies that allow them to compete on a global level even though they are not necessarily very large. Just think about Facebook, which in 2014 bought WhatsApp – a company with just 60 employees – for 19 billion dollars. Then there is Uber, founded in 2009 on the initiative of its founder Garett Camp, which now provides a private car transport service to millions of people every day, and Airbnb, which was opened in October 2007 by Brian Chesky, and in 2018 reached over 150 million users worldwide.

Notably, adopting a broader perspective on corporate governance means recognizing the importance of the following principles:

- Although public companies no longer necessarily represent the ideal model as posited by the Anglo-Saxon literature, new ownership structures will not completely replace them. Public companies will keep their relevance, especially in industries with high capital intensity such as utilities.
- Different ownership structures exist and there is no evidence that there are superior forms, or that some models are more suitable than others for carrying out certain economic activities. For instance, in Italy around 66% of companies listed on the Stock Exchange are family-controlled firms[1] (AUB Observatory, report 2019). According to an article that appeared in The Economist, the growing global relevance of family-controlled firms is explained by a combination of factors, including the shift in the modern economy towards areas of the world – particularly Asia – where this ownership structure represents the backbone of the economy.
- Similar economic activities are often carried out by different structures with comparable results. For example, the players in automotive sector range from pure public companies to family-controlled companies, state-owned companies or coalitions.
- Strategic choices are influenced by ownership structures, not only by external factors. In addition, management studies focusing only on the role of top managers in defining effective and far-sighted strategies, do not completely represent the way in which decision making occurs.

- Ownership, governance and strategy are three variables interconnected with each other.

13.2 The variety of ownership structures

Within the capitalist model, we distinguish between two important characteristics of the ownership structure:

- The degree of ownership concentration.
- The owner identity.

Ownership concentration refers to the number of shareholders and the share in the capital held (or equity participation) by each of them. Joint consideration of these elements makes it possible to identify some emblematic cases:

- *A private company with only one shareholder, who owns all of the equity capital* (100 percent of the shares). This case involves companies that are often not large, and in which ownership rights are concentrated in the hands of a single person who typically exercises both the functions of governance and management. This company can be successful, especially if led by the entrepreneur-founder, but with significant question marks on the ability to evolve the governance structure to pass the baton to future generations.
- *A private company with several shareholders.* This is an equally widespread form of enterprise, characterized by the equity capital being shared by a variable number of people (two in the simplest case, several dozen in the most complex cases), and by different types of people (members of the same controlling family; coalitions of controlling families; mixed coalitions of families, and other entities, such as other firms or private equity funds).
- *A listed company with a controlling shareholder (or blockholder).* A first category of listed company that is very widespread throughout continental Europe is one with a large number of minor shareholders and a single shareholder who possesses a sufficient percentage of shares to allow him/her to appoint the majority (or all) of the Board of

Directors. In this respect, it is not necessary to hold an absolute majority of the shares (50 per cent+1) in order to be the blockholder, since it is sufficient to hold the majority of the voting rights usually represented at shareholders' meetings.

- *A listed company controlled by another company or by a shareholders' agreement.* A variant of the previous model is represented by a listed company with a controlling shareholder represented not by a single individual or a family, but by another company or by coalition of investors linked together by a shareholders' agreement.
- *A listed company without a controlling shareholder*, i.e., with a large number of shareholders who cannot (because of the small number of shares held), or do not want (the case with many institutional investors), to participate directly in the governance of the company, and in the appointment of representatives to the governance bodies. This is the case of the public company.

Turning to the analysis of the identity of the controlling shareholder or blockholder (i.e., the owner identity), it is fundamental to understand the dominant economic objectives of owners. Among the various possible taxonomies, one of the most common in the literature is that proposed by Thomsen and Pedersen (2000):

- *Families or individuals*. Families and individuals often play the dual role of owners and managers. This means that they represent the only category of shareholders who act in their own name and on their own behalf, and not through representatives, thus favoring a natural alignment of interests. At the same time, as families or individuals typically invest a large portion of their wealth in the business, family-owned enterprises are potentially more risk-averse than managerial enterprises.
- *Institutional investors*. A second large category of "owners" consists of a broad category of mutual funds, pension funds, and insurance companies. Institutional investors denote a greater propensity to risk, a relatively long-term horizon, and a close relationship between the company and its management. In addition, the fact of owning a large portfolio of shares, as well as being regularly rated based on their

financial performance, makes institutional investors particularly oriented towards the creation of shareholder value.

- *Financial institutions*. Although corporate ownership by financial institutions is not widespread, and in some cases is even prohibited, it plays a very important role in countries under German law as well as in Japan.
- *Business groups*. Holding companies that can pursue a financial or synergy approach to corporate strategy, as discussed in Chapter 8.
- *State or other public administration entities or agencies.* The reasons for state intervention in ownership of companies can be manifold, and generally lie in the realm of market failure, or in the political relevance of the good or service offered.

Building on the notion of ownership concentration, we propose some simple dichotomies to codify the ownership structures.

- *Companies with controlling shareholders versus public companies.* This is the simplest dichotomy, which takes into account the level of ownership concentration to distinguish between companies with fragmented ownership (*public companies*), and those with a majority shareholder (*e.g.,* family-controlled firms).
- *Companies with a strong controlling shareholder vs. a weak controlling shareholder*. An important distinction is between a "strong" (or absolute majority) controlling shareholder, and a shareholder (by absolute or relative majority) with a relative (and contestable) majority.
- *A monolithic controlling shareholder (a single individual or entity) vs. a coalition of numerous and unequal shareholders*. A further classification distinguishes between the control exercised by a single shareholder (by absolute or relative majority), versus a coalition of various shareholders who have varying degrees of power and interests. If the latter diverge, negative effects on the long-term strategic choices usually arise.

Among the dichotomies referring to the owner identity:

- *Controlling private shareholder vs. public shareholder*. While controlling private shareholders usually have in common the desire to maximize the firm's profitability, a controlling public shareholder will be subject to strong pressure from political parties to define broader strategic objectives.
- *Purely financial controlling shareholder vs. industrial partner, customer, competitor or supplier*. A second important difference with respect to the identity of the controlling shareholder concerns its nature, i.e., whether it is a financial shareholder interested in taking advantage of risk diversification, or a partner, customer, competitor or supplier shareholder, whose controlling stake in the company is for benefitting of some kind of synergies.
- *Controlling shareholder with little knowledge of the business vs. controlling shareholder with business-related knowledge*. This distinction is particularly important in order to understand the type of contribution a controlling shareholder will be able to make to the business, and to understand whether it represents "the best possible owner."
- *Controlling shareholder with cash to burn vs. leveraged shareholder*. A controlling shareholder with excess cash is considered more willing than others to inject new equity capital and make the necessary investments for growth; whereas, a leveraged controlling shareholder will be primarily concerned with generating income for distributing dividends for the sole purpose of repaying its debt.

Finally, ownership behaviors may be also subject to external pressures, which include pressures from stakeholders without ownership rights (authorities, workers, local communities, consumer movements, etc.) and pressure from the activism of non-controlling institutional investors.

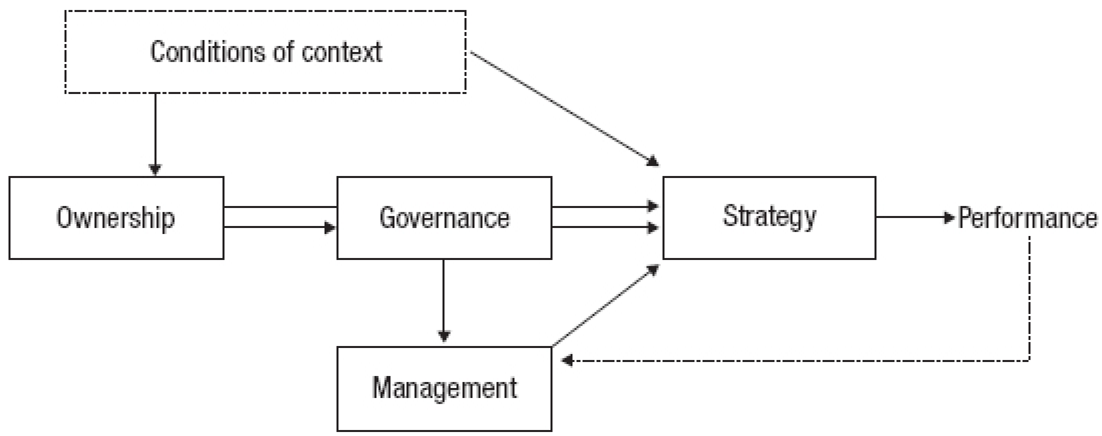
13.3 The role of ownership in corporate strategy

Although both the literature and the practice of corporate governance have often looked at ownership structures as an exogenous variable,[2] we prefer to give them a more prominent role. Ownership is very often the offspring of the institutional and legal context to which it belongs, determining a close parallelism between models of capitalism and prevailing ownership structures.[3] Then, if we exclude the rare cases of pure public companies without any influence by active institutional investors, the ownership always exercises a direct or indirect influence on strategic decision-making and, in turn, on performance.

To highlight the role of ownership, we can refer to the ownership-governance-strategy (OGS) model, which describes a causal relationship between ownership, governance and strategy as shown in Figure 13.1. In particular, the model assumes:

- The centrality of the ownership structure, which is also strongly connected to the level of efficiency of the financial markets, and to the characteristics of the capitalist model in which the company operates.
- The existence of causal relationships between the variables that see ownership as the ultimate determinant of the choices of governance and management, as well as the resulting strategic choices.
- The existence of contextual conditions exercising a direct influence on strategy, regardless of the will of the governance bodies, and thus leading to a set of forced choices that the majority of companies will try to pursue. Think about the tension toward obtaining greater efficiencies during a period of crisis, or of the upheavals in the ownership structures due to opportunities or the need for mergers and acquisitions between companies.

Figure 13.1 **The causal relationships between ownership, governance, and strategy of firms: the OGS model**



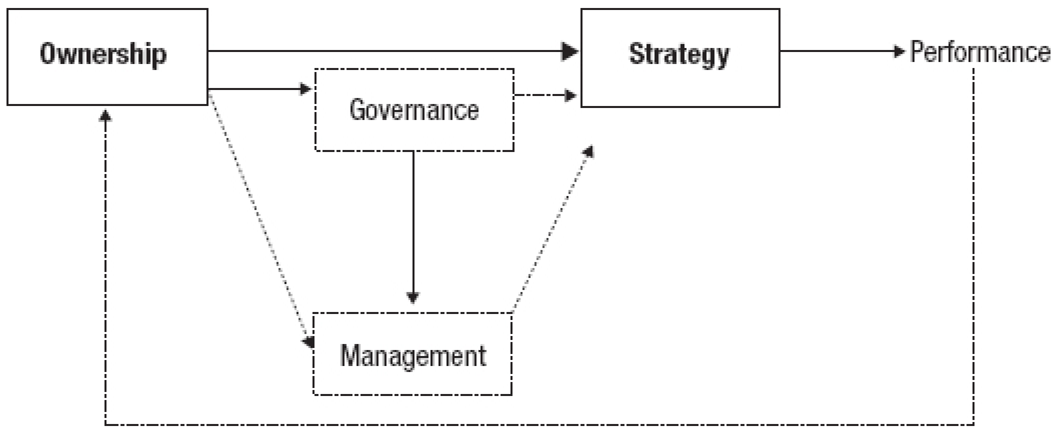
Source: A. Minichilli, *Proprietà, governo e direzione delle imprese*, Milan, Egea, 2012.

The empirical evidence supports the adoption of a theoretical model based on contingency arguments, according to which there are no universally valid configurations of the same. Only through an analytical process is possible to consider the various elements together with their relationships, and to identify the most suitable solutions to meet the company's expectations and those of its owners.

Building on the OGS model, we can discuss two very common scenarios that can arise in managing firms: strong owners vs. weak owners.

If ownership plays a strong role (as in the case of firms with a controlling shareholder), governance and management tend to adopt a subordinate position with respect to the choices and desires of owners, leading to corporate governance choices oriented above all to respecting Corporate Governance codes, at least for listed companies (Figure 13.2). This configuration is often adopted by family-controlled firms. By setting the business vision and fixing the risk/reward expectations, family ownership broadly impacts on some strategic choices. Moreover, the latter can also reflect family needs related to desire to keep families in harmony or to manage succession.[4]

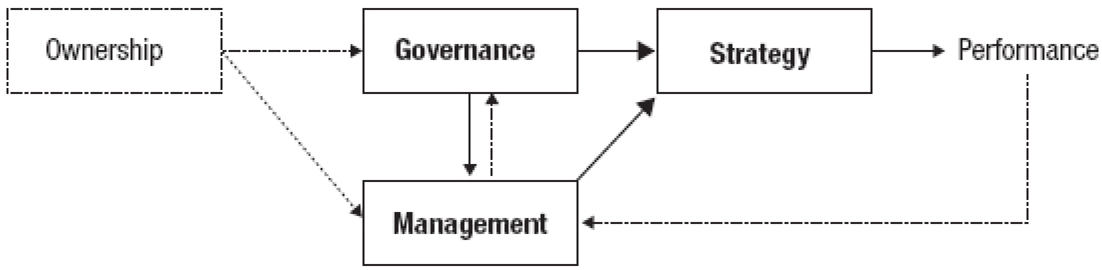
Figure 13.2 The OGS model in firms with a controlling shareholder



Source: A. Minichilli, *Proprietà, governo e direzione delle imprese*, Milan, Egea, 2012.

If ownership plays a weak role (as in the case of broad-based ownership typical of a public company), it is likely that the governance and management bodies will influence strategic choices significantly because they have greater power in the firm (Figure 13.3). This is the reason behind the tendency of the Anglo-Saxon capitalism to emphasize the impact of corporate governance on strategic choices, and in turn, on performance. For example, many studies focus on the relationship between the presence of independent directors on the board and some key choices of corporate strategy such as related or non-related diversification.

Figure 13.3 **The OGS model in public companies**



Source: A. Minichilli, *Proprietà, governo e direzione delle imprese*, Milan, Egea, 2012.

The analysis of the possible variants of the OGS base model can be summarized with two related considerations. The first regards the importance of ownership in the planning of other variables; the second regards the need to be able to interpret the fit between the context conditions and the existing ownership structure, and between that structure and the most likely and suitable choices of corporate strategies. In that regard, some possible relationships between the characteristics of ownership structures and strategic choices are:

- *Private controlling shareholder, strong, monolithic, and with "excess cash."* The presence of a single private shareholder, with absolute majority control and substantial financial resources, creates the optimal conditions for courageous and expansive strategic choices. According to the agency theory, the interests of the company will tend to converge with the interests of those who exercise the majority of ownership rights. For instance, the controlling shareholder is generally in favor of additional R&D investments, radical changes of business model, low dividends or capital increases to fund growth (if they do not excessively weaken its control).
- *Heavily leveraged controlling shareholder*. A controlling shareholder with such characteristics is likely to have a limited portion of the company's equity capital and to opt for conservative strategic choices like divestitures of no core businesses for cash generation, limited investments, and a low orientation to growth strategies. In addition, the

controlling shareholder expects that the firm will pay high dividends, and will very often be opposed to the injection of new capital into the company, as well as to capital increases that would dilute its control.

- *Strong public controlling shareholder.* This specific ownership configuration may be beneficial for the strategy of the company and its stakeholders. This kind of controlling shareholder, in fact, will be able to make large investments, although they tend to be with low risk and to deliver rewards in the medium and long term. Public controlling shareholders are usually opposed to restructuring plans, which include divestments and cutting redundancies while they easily support acquisitions of other companies in financial difficulty, even in unrelated businesses, to order to ensure their survival, and, above all, to preserve their levels of employment.
- *Controlling shareholder, who is also a competitor, customer, or supplier*. This kind of shareholder is generally in favor of streamlining and restructuring operations to exploit synergies and of divesting from non-core activities. Specific considerations apply when the controlling shareholder is a customer or supplier because it can be a related party in a firm's transaction. In such circumstances, the firm – especially if listed on the stock market – shall apply the regulations of related party transactions to protect the interest of minority shareholders.
- *Purely financial, but active minority shareholders.* Financial shareholders will normally oppose to corporate diversification, because they prefer to hold single businesses firm in their portfolio. However, active minority shareholders (such as private equity funds in a private company, or institutional investors in a listed company) can exercise considerable influence over strategic choices. For instance, they may be in favor of rationalization or restructuring plans.
- *Stakeholders without ownership rights but with great influence.* A final, very special circumstance concerns the impact exercised by influential stakeholders, such as an authority in a highly regulated sector. Although they are extraneous to our model so far, they remain relevant actors because they can exert an external influence on strategy.

13.4 The centrality of the Board of Directors

Anglo-Saxon literature believes that the key issue of corporate governance regards the configuration and functioning of the Board of Directors (BoD), and how these characteristics allow it to play its two central roles:

a) The *role of control* over management.
b) The *role of service* or *support* for management within the decision-making.[5]

Both roles have the goal of ensuring that BoD is accountable, and that management is made accountable too. In addition, their implementation should create a check-and-balance of powers, responsibilities, and interests to protect the interests of owners and those of the firm.

Corporate governance best practices for listed companies have been codified in many countries to help owners and firms to work on the composition, structure, and functioning of the BoD. In the Italian case, for example, ninety percent of companies listed on the Italian Stock Exchange[6] have currently chosen to formally comply to the latest edition of the Corporate Governance Code, with the logical consequence of convergence in the corporate governance structures.

13.4.1 Composition, structure, and functioning of the BoD

As regards to the *composition of the BoD,*[7] the classic dimensions of analysis refer to the following ones:[8]

- *The number of board members (or directors)*, that should be sufficiently large to bring heterogeneous competences, and sufficiently small to allow for the effectiveness of decision-making process, but still adequate for the complexity of the firm in relation to its size (and sometimes, also in relation to the industry).
- *The presence of non-executive board members*, a majority of which should be independent.
- *The adequacy of the mix of executive and non-executive board members* with respect to the firm's characteristics and needs.
- *The diversity within the Board of Directors*, in terms of both competences and gender (the Italian Law 120/2011 on gender quotas

has led to the mass entry of women into the boards of listed companies).

- *The balanced representation of all interests*, with the inclusion of board members who safeguard the interests of minority shareholders.

The evolutionary analysis of these aspects, some of which are more consolidated (such as the number and mix of board members), and others more recent (such as the protection of minority shareholders and gender diversity), shows how the composition of the BoD has been substantially shaped by the Corporate Governance codes. If we consider some summary data on the case of Italy, starting as far back as 2006, the year in which the third edition of the Code came into effect,[9] we observe stable trends regarding both the BoD's size and the presence of non-executive board members (Table 13.1).

Table 13.1 Composition of BoD in Italian listed companies (evolution)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Number of board members	10.3	10.0	9.8	9.7	10.0	10.1	10.1	9.9	9.8	9.8	9.8	10.0	10.0	10.0
Non-executive board members (%)	71.7	67.8	66.9	66.7	68.9	70.2	70.5	69.9	70.5	70.8	71.3	73.4	75.0	75.0
Independent board members (%)	40.4	38.7	36.3	35.6	35.4	35.7	38.1	39.3	39.9	40.5	41.0	43.8	44.5	46.0
Firms with "minority" board members (%)	8.6	9.8	13.1	18.6	30.5	35.5	37.6	38.5	38.7	38.2	41.4	45.7	44.4	49.5
Women board members (%)	4.5	4.8	5.9	6.3	6.8	7.4	11.6	17.8	22.7	27.6	31.6	33.6	36.0	n.a.
Presence of at least 1 woman on the BoD (%)	33.9	37.2	43.8	46.4	49.6	51.7	66.8	83.5	91.9	98.3	99.1	98.7	99.1	n.a.

Source: Assonime, Emittenti Titoli, *La Corporate Governance in Italia: autodisciplina, remunerazioni e comply-or-explain*, 2019.

To the contrary, we see a certain reduction of independent board members from 2006 to 2011, partly due to a stricter definition of independence in the most recent editions of the Code, and partly due to the gradual larger incidence of minority-appointed board members (represented by investment funds or minority shareholder groups) who do not always meet the requirements of independence. Since 2012, the role of independent board members has started to grow again: a symptom of the greater substantial independence of the board over the past few years. With regard to the issue of gender diversity, the picture is much clearer. The law on female quotas has in fact produced considerable effects. The presence of women on the BoD of listed companies increased by approximately 32 percentage points between 2006 and 2018. All companies have at least one female director (99.1 percent in 2018).

Coming to *the structure of the BoD*,[10] the best practices provide for:[11]

- *Avoiding overlap (CEO duality) between the role of chairman and Chief Executive Officer* (CEO), with the goal of balancing powers within the BoD, and specializing the functions of the chairman (of a strictly organizational nature) with respect to those of the CEO (executive and leadership).
- *Identifying a lead independent director*, in the case of CEO duality, and in any case when the chairman is the controlling shareholder of the firm.
- *Establishing a significant number of committees* to assist and advise the BoD. These committees allow for fully dealing with a series of critical issues that would be impossible to examine during the BoD's meetings, including internal control and the selection and incentives (remuneration) of the board members and top managers.

Looking at it, the incidence of lead independent directors has seen a strong increase (introduced in the 2006 revision of the code), partially driven by the significant number of chairmen in the position of controlling shareholders. The same trend occurred for the adoption of nomination committees (whose functions were significantly redefined and strengthened with the update of the Code in 2011), the internal control committee (renamed the "control and risks committee" in the 2011 edition of the Code), and the remuneration committee (Table 13.2).

Table 13.2 Structure of the BoD of Italian listed companies (evolution)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
CEO duality (Chairman = CEO) (%)	32.0	39.3	30.9	29.0	30.9	30.9	31.4	30.5	32.6	32.5	27.3	25.3	26.2	26.4
Controlling shareholder Chairman (%)	–	–	12.4	14.7	15.1	16.4	18.8	18.8	18.3	18.9	16.7	20.8	18.2	19.1
Lead independent director (Lid) (%)	2.6	18.2	34.0	36.2	36.8	37.0	37.6	41.8	43.9	43.9	42.3	43.0	43.6	44.5
Presence of control and risks committee (%)	84.0	82.9	86.3	86.7	88.2	89.7	91.0	91.2	91.3	92.1	93.0	95.0	94.0	95.0
Presence of remuneration committee (%)	74.7	78.2	80.4	82.1	84.2	85.1	88.2	89.5	87.8	89.0	89.0	91.4	91.0	93.0
Presence of nomination committee (%)	11.2	12.7	11.7	11.8	15.8	16.4	20.0	44.4	49.1	50.0	54.6	56.6	60.0	62.7

Source: Assonime, Emittenti Titoli, *La Corporate Governance in Italia: autodisciplina, remunerazioni e comply-or-explain*, 2019.

Finally, best practices also include those for the *functioning of the BoD*, i.e., the set of mechanisms that favors the decision-making processes in performing various roles and duties. Although these aspects are certainly harder to measure than the previous ones, there are practices whose dissemination is strictly linked to the requirements of the Corporate Governance Code (Table 13.3).

Table 13.3 Functioning of the BoD of Italian listed companies (evolution)*

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Number of BoD meetings	9.7	10.1	10.0	10.3	10.2	9.9	10.7	10.2	10.1	10.6	11.2	11.1	11.2
Companies with meetings of only independent members (%)	–	–	57.7	67.3	70.6	74.5	57.8	60.9	62.4	61.7	69.7	65.8	68.6
Companies with evaluation of the BoD (%)	10.9	32.0	50.2	58.8	61.8	69.8	76.6	79.1	78.9	80.2	80.1	83.0	84.0

* The sequence in this case starts in 2007 due to the introduction of these tools (especially the meetings of only independent members and the evaluation of the BoD) only starting with the 2006 edition of the Code.

Source: Assonime, Emittenti Titoli, *La Corporate Governance in Italia: autodisciplina, remunerazioni e comply-or-explain*, 2019.

While the number of BoD meetings is essentially stable, we see a strong growth in the percentage of companies that hold meetings of only independent board members and companies that regularly carry out evaluation or self-assessment activities of the BoD.

In both cases, these are effective tools to guarantee the correct functioning of the BoD. While the meetings of only independent directors aim to ensure that the discussion among them is not conditioned by other subjects (and above all by any controlling shareholders in the BoD), the evaluation of the activity and effectiveness of the BoD should represent the periodic (annual) review mechanism of the composition and functioning of the BoD, to identify a series of possible improvements.[12]

13.5 Towards a modern view of corporate governance

In previous sections, we have briefly discussed the state of the art of the debate on corporate governance, and examined the role of both ownership and the Board of Directors in different contexts. We have also highlighted some limitations to the traditional approach to deal with corporate governance choices, namely:

a) The tendency to surrender to the passive role of ownership in contexts where it is particularly fragmented, and therefore unable or unwilling to affect business decisions (as in the case of public companies or weak owners).
b) The tendency of (listed) companies to apply the rules of governance codes in an adaptive sense, favoring an attitude of compliance instead of searching for quality governance.
c) The tendency to consider corporate governance as an issue relevant only for listed companies (partly as an indirect consequence of the previous points).

These three limitations contribute to damaging the quality of strategic decisions, which may be made without benefiting from the correct dialectic that should always exist between ownership, governance, and management. In other words, the real risks for firms are:

a) In fragmented ownership contexts, a dominant influence by the Board of Directors over the main strategic choices, if not truly excessive power or even an abuse of power.
b) In concentrated ownership contexts, a dominant influence by the owners on strategies, often with a limited or only formal role for the governance and top management.

In order to prevent this from happening, and to follow the guiding principle of corporate governance, we suggest either strengthening the role of ownership where it is very fragmented or strengthening the role of the board where the owners dominate it.

13.5.1 Strengthening the role of ownership (where it is weak)

Fragmented ownership has traditionally favored a passive attitude by investors, who are motivated essentially by financial objectives, and a short-term view of their investment. This traditional view is increasingly challenged by a new and more modern one. Factors such as the evolution of the debate on corporate governance, the overall increase of shares in the hands of professional investors, and the benefits of strong ownership (such as by families) especially during financial crises, have shifted the attitude of corporate owners from being typically passive (exit), to being gradually more active (shareholder activism) and entering into dialogue with top management (voice). This new attitude forces institutional investors to orient their behavior more and more towards strategic decisions, which actually create value for the shareholders (and to stakeholders more broadly).

Some recent cases represent this trend well. A first example is the spin-off of PayPal from eBay, strongly suggested by Carl Icahn, owner of the Icahn Enterprises fund, immediately after taking a stake of 2 percent in eBay in 2014. Although this proposal was initially opposed by eBay's top management and board, due to the significant synergies achieved in the past between the two businesses, in September 2014, eBay CEO John Donahoe himself changed his position and accepted Icahn's arguments about the online payment business having better prospects than the traditional one of web auctions. That is not all: in January 2015, eBay decided to appoint an Icahn representative to the board, and to accommodate many of the other strategic ideas that Icahn had provided to the management after becoming a shareholder.

A second case is that of PepsiCo, which since 2013 has been subject to persistent pressure from Nelson Peltz, an activist of the Trian Partners fund, who argued for the need to separate the soft drink business from the snack business. Although the proposal was ultimately rejected by the board of PepsiCo, the initiative was the stimulus for the launch of an important cost-cutting plan from which the company and its shareholders are still benefiting.

13.5.2 Strengthening the role of governance bodies (when ownership is strong)

Our evolutionary analysis of the composition, structure, and functioning of the Board of Directors shows a substantial homogeneity in the behavior of listed companies with respect to the measurable indicators of effectiveness of corporate governance. This also happens in case of a strong concentration of ownership, which makes the governance bodies structurally weaker in the dialogue with family owners and shareholders.

For these firm, it seems necessary to go beyond compliance, i.e., beyond formal requests for compliance with the Governance Code. To do this, a greater awareness of the importance of strong and competent governance bodies is required together with more attention to recruit top-notch directors. This could be done, for example, through:

a) A greater emphasis on independence and competence of the Board of Directors, through the appointment of directors with (personal) independence of judgement – and who are put in a position to exercise it – as well as directors with skills that are consistent with the company's strategic needs.
b) The improvement of the quality of information to be discussed by the BoD and the search for an open and constructive debate within the BoD, so that directors – especially independent directors – can fully contribute to major strategic decisions (and not just formally ratify decisions made elsewhere).

c) Continuous training of directors, especially in the case of new appointments (with appropriate induction activities, especially regarding the industry), as well as through a number of *ad hoc* (at least once a year) and long-lasting (one or two days) meetings of the Board of Directors, to be held outside the company with the aim of discussing and sharing a common vision on long-term strategies.[13]

13.5.3 Increasing the importance of governance in private companies

Although the issue of corporate governance was born in the context of public companies, the topic is of growing interest for private companies. Nowadays there is a greater awareness among entrepreneurs that the ability to move effectively in ever-changing markets will depend more and more on the quality of governance. Clearly, strong resistance towards effective governance is understandable, due to the high costs of a good system and the complexity associated with the transition from a family to a professional model of governance.

To facilitate and support this cultural transition, there is a growing spread of corporate governance codes for private or unlisted companies, that are very similar to the well-known codes for listed companies. Among these, the first voluntary code was the Buysse Code in Belgium (first edition in 2005, now in its third edition in 2016), which includes recommendations for private companies not only in terms of the Board of Directors, but also on the quality of entrepreneurial action, corporate social responsibility, and specific provisions for family-owned companies.

Based on the experience of other European countries and the empirical evidence from the AUB Observatory on Italian family firms, the first Code of Corporate Governance for Unlisted Family-Controlled Companies (called Principles for Unlisted Family-Controlled Companies)[14] was published in Italy in 2017. This Code aims to go beyond previous family governance models, in order to enhance efficient and effective mechanisms, and proposes 13 principles that can be applied to all private family companies with revenues higher than 10 million Euros, plus 6 other principles for larger and more complex family companies.

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[1] Family-controlled companies are not just small- and medium-sized private enterprises with predominantly local relevance, as is often believed. A significant number of them are medium-sized and large, and listed firms, with a strong international outreach, often still controlled by a single family.

[2] Aguilera et al. (2015); Minichilli (2012).

[3] La Porta et al. (1998); Weimer and Pape (1999).

[4] Miller, Minichilli and Corbetta (2013).

[5] Specifically, a controlling role means the sum of the board duties that refer to the following aspects: (i) evaluation of the results achieved by the firm (financial, competitive, and social performance); (ii) verification of the quality of the decisions made by the top management; (iii) control concerning respect for applicable laws and rules; (iv) verification of the efficacy of internal reporting; (v) evaluation of main company actors, and in particular of the CEO. To the contrary, a service or support role means: (i) the contribution to the firm's strategic decision-making process; (ii) the examination and approval of strategic and industrial plans; (iii) the examination and approval of important strategic decisions, and of extraordinary operations (such as transformations, mergers, acquisitions, split-ups, etc.); (iv) the choices relating to the firm's financial structure, and in particular the choices relating to the characteristics of firm indebtedness; (v) the definition of compensation policies for the top management, to the extent under the competence of the BoD; and (vi) the definition of the fundamental rules of corporate governance, within the group.

[6] Assonime (2019). Out of the 22 companies that do not adhere to the latest edition of the Corporate Governance Code (a slight increase: there were 19 in 2016), 8 companies adhere to previous editions of the Code.

[7] Finkelstein and Mooney (2003); Minichilli (2012).

[8] For specific provisions regarding the aspects listed below, we refer to the articles of the various editions of the Corporate Governance Code, and in particular to the 2006 edition (in effect until 2011), and the recent 2011 edition (in effect starting in the 2012 financial year), subject to new updates in 2014 and then in 2015.

[9] The analysis proposed here refers to the years 2006-2019, i.e. from the moment of entry into force of the second edition of the Corporate Governance Code, since the previous data (referring to 2000-2005, the first version of the Code) are not very uniform.

[10] Finkelstein and Mooney (2003); Minichilli (2012).

[11] In this case as well, we refer to the Corporate Governance Code for further details.

[12] Minichilli, Gabrielsson and Huse (2007).

[13] Lorsch and Clark (2008).

[14] Marchetti et al. (2017).

14 The Roles and Functioning of Corporate Headquarters

by *Guido Corbetta*

14.1 Multibusiness firms or business groups

Until a few years ago, the research on multidivisional firms was more focused on diversification and portfolio issues than on parenting issues, with the result that the number of studies on corporate headquarters has historically been limited despite the crucial role that they play in building a corporate advantage.[1] This trend has changed in the last decade with the development of integrated frameworks to understand the roles, activities, and structures of corporate headquarters and their impact on performance.

The corporate headquarters, corporate parent or corporate center is “the firm’s central organizational unit, (structurally) separated from the operating units (business or geographic units), hosting corporate executives and staff, as well as central staff functions that fulfill various roles for the overall firm.” [2]

From an organizational standpoint, the identification of headquarters is not always as simple as one might expect. Of course, in multidivisional structures they can easily be separated from the rest of the firm. If the firm creates additional layers intermediating the relationship between the center and divisions, specialized per sectors or geographical regions, the headquarters also includes them in its own structure. In organizations with a hybrid or matrix form, on the other hand, corporate centers consist both of the units to which the divisions report and all the others for the activities they perform in the interest of the overall firm. Finally, the situation is objectively less clear when the firm opts for a functional form to manage its presence in multiple businesses. Here, we can assume that the corporate headquarters consists of the CEO and managers not working only for a single business. For example, a manager working on a project impacting more than two businesses will be conceptually included in the corporate center.

From a legal standpoint, a firm can organize its corporate headquarters following two different corporate structures:

- *Single corporate entity*. In this case, the corporate headquarters is an organizational unit of the same legal entity where the businesses are located.
- *Business group*. In this case, the corporate headquarters is represented by the holding company controlling the network of subsidiaries or affiliates operating in the various businesses in which the firm has invested.[3]

In business groups,[4] each subsidiary company is an independent legal entity with its own Board of Directors and a leadership team. This implies that it answers to its own shareholders, that are different than those of the holding company. It can raise its own capital and debt autonomously, pursue its own strategy to face competition, and create its own incentives for managers.

The core shareholders of the holding company can also have a direct relationship with the subsidiaries. For instance, owners of the holding company may serve as directors or board members in the subsidiaries. Or, they can serve as members of various committees such as a strategic or investment committee. In some case, owners can even be appointed as CEOs of the subsidiaries.

By and large, business groups provide several advantages over the option of the single corporate entity, which can help reduce the risk of the corporate headquarters expanding its competences and size beyond measure without actually adding any advantages to businesses. The main advantages are the following:

- The presence of separate Boards of Directors allows subsidiaries greater autonomy in decision-making processes, reducing the potential negative influence that can be exercised by corporate headquarters.

- The performance management system of each subsidiary can be tailored to its specific needs. In a single corporate entity, this system is more difficult to differentiate into divisions because it contributes to shaping the common organizational identity or culture.
- The cash flows generated by subsidiaries can remain available to them (unless they are distributed as dividends) without being automatically absorbed by the corporate headquarters, that for instance, may use these resources to subsidize underperforming businesses.
- One or more subsidiaries can be listed.
- A minority stake in one or more subsidiaries or affiliates can be sold to financial or corporate investors.
- An unrelated diversification strategy can be pursued more effectively.

Business groups have been broadly criticized in the developed world since the late seventies for their poor performance due to implementation of ineffective unrelated diversification strategies, as described in Chapter 8. However, they have not disappeared either in developed economies or in emerging markets and the developing economies, in which they thrive as demonstrated by many successful cases such as the Tata group or the Marugappa group in India. Therefore, they represent a legal and organizational structure of a certain significance.

14.2 The roles of the corporate headquarters

A corporate headquarters can play five different roles.

1. *Managing the portfolio strategy model (in agreement with the shareholders)*. Corporate headquarters have the power to choose (or propose to the Board of Directors) how to diversify and how to allocate resources in the business portfolio. This power can be exercised either directly by approving all major capital investments or indirectly by setting the criteria to approve capital expenditures within divisions or subsidiaries.[5]
2. *Building and exploiting the corporate valuable resources (i.e., being the custodian of corporate valuable resources)*. Multibusiness firms

develop resources which have particular value for achieving a corporate advantage, which we have referred to as corporate resources. Corporate headquarters have the duty to identify those resources, to promote their transfer and sharing between businesses, and to make all of the investments necessary to protect their value over the years. In addition, they are also responsible for reshuffling resources across businesses to accelerate strategic innovation. For example, this can happen by monitoring the firm's innovation ecosystem (research centers, universities, startups, competitors, etc.) to sense new opportunities for learning.

3. *Performing mandatory administrative duties*. Corporate headquarters must always perform some administrative duties to ensure that the firm fulfills its legal, regulatory, fiduciary, and stakeholder obligations. The typical functions and activities falling under this role regard general corporate management, taxation, treasury, financial reporting and control, company secretariat, and other specific activities such as investor relations for listed firms.
4. *Providing shared services.* Corporate headquarters can provide additional services to businesses by centralizing activities such as information technology, research and development, and marketing.
5. *Designing the organizational context (i.e., being the organizational architect)*. Corporate headquarters is responsible for the design of the organizational macrostructure, the shape of the corporate culture, the definition of operating systems and processes to run the firm, and the decisions about key people. For example, it designs and implements planning and control systems, human resource management systems and information systems, or sets policies or standards in different areas such as that of the Safe Health Environment (SHE). In business groups, the corporate headquarters usually influences the appointment of directors in the board of subsidiaries.[6]

14.3 The structure of the corporate headquarters

There is a significant body of research on the structure of corporate headquarters, whose costs can range from 2 percent to 7 percent of sales in large multibusiness firms according to a study published by Roland Berger in 2013.[7]

First of all, Young and Goold provides some interesting findings based on the analysis of a broad sample of cases located in six different countries:

- The size of corporate headquarters varies enormously across industries and geographies.
- The size of corporate headquarters depends on the firm's size and the portfolio strategy model adopted.[8] Firms opting for a single industry or multi-industry model tend to have larger headquarters than those pursuing a conglomerate model. The reason lies in a greater number of operational synergies to put in place and coordinate, and in a higher centralization of activities at corporate level in the case of a corporate strategy with a synergy approach.
- The firms with larger corporate headquarters deliver better performance (on average). This finding, however, has a methodological weakness to highlight: the causal direction of the relationship has not been proved. In other words, it is not demonstrated whether larger corporate headquarters produce better results or better results favor greater investments in corporate headquarters.

Another study conducted by Collis, Young, and Goold demonstrates that a multibusiness with 20,000 employees employs an average of 124 people in the headquarters in Europe, 255 in the U.S., and 467 in Japan 467.[9] So there are evidently cultural and institutional factors impacting on the size of the corporate center.

To attempt to understand how much and which variables can influence the distribution of activities between the corporate level and the business level, another empirical study on a sample of approximately 4,000 firms operating in the U.S., Europe, and Asia, reached the conclusion that the variable of trust has a significant impact on this choice. A high level of trust in the countries where the corporate headquarters and the business units are located increases the degree of decentralization towards subsidiaries with the effect of reducing headquarters' size.[10]

Other scholars have observed that headquarters naturally evolve over time because they go through a life cycle divided into four stages characterized by specific challenges and threats to performance: youth and enthusiasm; adolescence and ambition; maturity and best practices; and change and the struggle for survival.[11] Therefore, the structure of headquarters is always evolving to align with the change of internal and external factors.

Lastly, a study published by the Boston Consulting Group (BCG) based on an analysis of 150 cases came to the conclusion that the approach to being a corporate headquarters (defined in this piece of research as the parenting strategy) has an impact on organization.[12] Notably, the approaches identified by BCG are:

- *Functional Leadership*, present in 23 percent of the cases analyzed. The corporate headquarters contributes to creating value for businesses through functional excellence, shared corporate resources, and central services. In these cases, the corporate headquarters actively participates in the processes of strategic management of the divisions and subsidiaries, establishing functional policies. This parenting approach requires large corporate functions and complex processes and policies.
- *Strategic Guidance*, present in 22 percent of the cases analyzed. The corporate headquarters contributes to defining the strategic direction of divisions and subsidiaries thanks to its superior knowledge and experience. The involvement of the corporate headquarters in the process of strategic management of the divisions and subsidiaries is more important than in many other models. This parenting approach does not require large corporate functions and complex processes and policies.
- *Synergy Creation*, present in 20 percent of the cases analyzed. The divisions or subsidiaries derive significant benefits from synergies in marketing, sales, and operations. Each division or subsidiary remains accountable for their performance and the corporate headquarters limits their interference on strategic and operational matters, even though it can centralize various functions and offers a great variety of shared services such as a central talent management program.

- *Hands-On Management*, present in 17 percent of the cases analyzed. The corporate headquarters is deeply involved in the strategic management of divisions or subsidiaries by setting financial targets, providing strategic guidelines, or exerting functional leadership. In these cases, it assumes responsibility for defining a strategic plan at the group level, that is then applied in the single firms of the group.
- *Financial Sponsorship*, present in 13 percent of the cases analyzed. The corporate headquarters acts only to assist the divisions or subsidiaries to obtain financial advantages. In this case, it is not significantly involved in the strategic management of the subsidiaries.
- *Hands-Off Ownership*, present in 5 percent of the cases analyzed. The corporate headquarters is focused on the creation of value by adding new businesses to the portfolio or by divesting from others without any ambition of exercising central control over strategic or operational functions. In these cases, the participation of the corporate headquarters in the strategic management of the single companies is clearly very limited.

Given that the research on corporate headquarters shows that the size and staffing of this organizational unit depend on many internal and external factors and that the final choice is the outcome of a contingency approach to organizational design, two specific factors are particularly important to consider in this domain:

1. How a firm applies the governance and compliance, added value and capital markets logics in making corporate strategy decisions impact on headquarter structure.
2. When to centralize an activity at the corporate level, when to decentralize it at business level, or when to outsource.

As regards the first point, the governance and compliance logic identifies the set of roles and activities that cannot be delegated to divisions and subsidiaries: (1) choosing the portfolio strategy model; (2) delivering obligatory company functions and duties; (3) designing the macro-organizational structure, key operating systems, and processes, and (4) making people decisions (above all for those who hold top positions in the organization).

The application of the added value logic impacts the discretionary role of headquarters. The more the firm aims to exploit a large variety of corporate valuable resources and operational synergies, the more the size of the corporate center will expand.

Lastly, the application of the capital markets logic can also influence the headquarters' structure. If the firm believes that sooner or later a business unit will be sold to third parties, the centralization of some activities (option b) is not likely to be pursued. First, the potential buyers could be interested in acquiring only independent divisions. Second, corporate headquarters has no interest in overstaffing the central units as it will ultimately be necessary to restructure them when the business is sold.

As regards to the second point, the size and staffing of central units are influenced by how corporate activities are performed, which depends on three alternatives:

a) Delegating an activity to divisions or subsidiaries (decentralization).
b) Performing an activity in-house (centralization).
c) Outsourcing an activity to an outside organization.

The choice between alternatives b) and c) is determined by reasons of efficiency, effectiveness, or/and flexibility. There will be an incentive to outsource if the outside organization can carry out activities at a lower cost than in-house, if on its own it can leverage distinctive competencies to better perform a specific activity or if the firm wants to transform fixed costs into variable costs to become less dependent on market conditions or limits its own capital expenditures. Sometimes, outsourcing can be limited by opportunity factors. For example, a centralized and sophisticated IT service can be kept in-house because the corporate headquarters does not want to lose control over innovation processes or for reasons of security or privacy, or due to a cultural preference.

The choice between alternatives a) and b) is still based on reasons of efficiency and effectiveness. Centralization (option b) allows for exploiting economies of scale, developing and allocating corporate valuable resources more effectively, optimizing their use when demand exceeds availability, or benefitting from learning processes. By centralizing it is also possible to limit some opportunistic behavior of businesses that tend to use corporate resources only for maximizing their self-interest, without worrying about the impact on the overall firm. On the contrary, through greater decentralization a firm can better motivate business-level managers, facilitate quicker decision-making, and strengthen the ability of the division to adapt to changes.

14.4 The value added (or destroyed) by the corporate headquarters

Corporate headquarters aims to create added value for businesses through four fundamental organizational mechanisms:

- *Stand-alone influence*, it influences the strategies and performance of each division or subsidiary separately.
- *Linkage enhancement,* it seeks to enhance linkages across divisions or subsidiaries to exploit synergies and benefit from economies of scope and scale.
- *Central functions and services,* it promotes the centralization of activities at the corporate level to achieve economies of scale or scope.
- *Corporate development,* it inspires the evolution of the portfolio of businesses. For example, by buying or selling businesses, by creating new businesses through internal development and corporate entrepreneurship, or by forming strategic alliances.

The mechanisms can be implemented jointly and some of them can be used to manage the relationships with certain divisions and subsidiaries, and others with other divisions and subsidiaries.[13]

By investigating how firms implement the four mechanisms, Campbell et al. have been able to identify a list of sources of added value and those of subtracted value.[14]

The sources of added value are nineteen in total and are divided into two conceptually different categories. On the one hand, corporate headquarters can command or directly influence value creation processes in each division or subsidiary through ten sources of *vertical added value*. On the other hand, corporate headquarters can encourage coordination and collaboration among divisions or subsidiaries through nine sources of *horizontal added value*.

The list drawn up by Campbell et al. is not exhaustive, as indicated by the authors themselves. In addition, two or more sources of value can thus co-exist in a specific corporate initiative, making the distinction between vertical and horizontal categories not always easy to trace.

Concerning the vertical sources, the corporate headquarters can add value by:

- Removing and replacing less competent managers with more competent managers (*people decisions*).
- Supporting divisions or subsidiaries to formulate a more effective strategy (*strategy*).
- Setting new or more challenging targets for divisions or subsidiaries (*goals*).
- Introducing powerful performance management systems to ensure that divisions or subsidiaries are more motivated and focused on achieving strategically relevant goals and on swiftly implementing coherent actions (*performance management*).
- Setting policies and standards in areas other than performance (*policies and standards*).
- Facilitating the relationships of divisions or subsidiaries with the relevant influential stakeholders, including shareholders (*relationships*).
- Providing valuable technological resources to help divisions and subsidiaries succeed in their industry. For example, technological resources can improve product development processes or the efficiency or effectiveness (or both) of manufacturing processes (*technology*).
- Providing expertise not available in divisions and subsidiaries, which can become a driver to build a competitive advantage (*expertise*).
- Developing and providing a brand that helps divisions or subsidiaries achieve a competitive success (*brand*);
- Providing all kind of resources (such as financial resources or corporate finance competences) to improve the financial management of a division or subsidiary (*financial engineering*).

Whereas, corporate headquarters can create horizontal added value by:

- Favoring the coordination of shared customers or clients across multiple businesses (*one face to the customer*).
- Encouraging a division or subsidiary to sell products or services of other divisions or subsidiaries as well (*cross-selling*).
- Benefitting from economies of scale in performing one or more value chain activities, for example by combining multiple purchasing needs or by coordinating manufacturing activities (*economies of scale*).
- Favoring the transfer or sharing of scarce resources between divisions and subsidiaries such as technological competences, distribution channels, and brands (*shared resources*).
- Coordinating strategies across divisions and subsidiaries when the firm competes with the same rivals in the same markets (*multipoint competition*).
- Linking and coordinating the divisions or subsidiaries operating at different stages of the value chain so as to reduce working capital or waste, or gain other advantages linked to vertical integration (*vertical integration*).
- Incentivizing divisions and subsidiaries to share knowledge and good practices (*sharing knowledge and good practices*).
- Promoting the development of new businesses by combining existing business resources (*new business development*).
- Diversifying, spreading and reducing the overall risks of the firm by assembling the portfolio of businesses (*risk management*).

With regard to the sources of subtracted value, they are meant as a set of actions promoted by the corporate headquarters that negatively impacts the performance of divisions and subsidiaries. Of course, when subtracted value is greater than added value, the parenting strategy will be questioned for a lack of effectiveness. Building also on the results of a study conducted by the consultants at the Boston Consulting Group,[15] Campbell et al. identify four broad categories of sources of subtracted value:

- *Negative influence.* The corporate headquarters will exercise a negative influence if (1) its competences are inadequate to provide strategic guidance to divisions and subsidiaries because it does not understand their critical factors of success; (2) its decision-making is guided by political or power motives rather than the goal of helping divisions and subsidiaries strengthen their competitive advantage, or (3) it interferes in the management of divisions or subsidiaries with the effect of demotivating business-level managers.

- *Overhead costs*. If corporate headquarters offers services that are inefficient or no longer necessary, overhead costs will destroy value at the business level.
- *Resource competition.* Resource competition mainly impacts marginal divisions and subsidiaries that may not receive adequate attention in their strategic decision-making (namely, in resource allocation through portfolio strategy decisions) due their limited size. Resource competition also refers to the case where stronger divisions or subsidiaries are forced to subsidize weaker ones.
- *Cost of complexity.* The costs of complexity emerge when divisions and subsidiaries waste too much energy and resources on influencing decision-making at corporate level, and when they experience a lack of responsiveness due to high coordination and collaboration requirements with other businesses.

It is rare for a multibusiness firm to be able to eliminate all of the possible sources of subtracted value, because corporate headquarters tend to increase their sphere of influence and power in organizations, even only to justify their existence, or worse, due to ambitions of power of some leaders. However, to maximize the value added and minimize the value destroyed, we recommend:

- *Engaging the Board of Directors (in the case of a business group, the Board of Directors of the holding company).* The Board of Directors must periodically monitor the efficiency and effectiveness of headquarters. Independent directors (or independent board members) have a crucial role in carrying out this task, because they have no conflicts of interest, unlike executive directors, who could aspire to an increase of their organizational power.
- *Prioritizing the added value sources to implement*. By prioritizing sources of added value the firm can substantially reduce the risks of committing to activities whose benefits are more uncertain.
- *Deploying a performance management system able to measure the added value by the corporate headquarters*. A periodic evaluation of

the value added by corporate headquarters helps reduce the risk of subtracting value.

- *Listening to feedbacks from business-level managers*. Business-level managers are the persons who more than anyone else should be able to identify the weakness of headquarters, because they have direct experience of how some corporate activities risk undermining the competitive advantage of divisions or subsidiaries. Of course, sometimes these feedbacks should be carefully weighed, because such managers could pursue their self-interest rather than the interest of the firm.

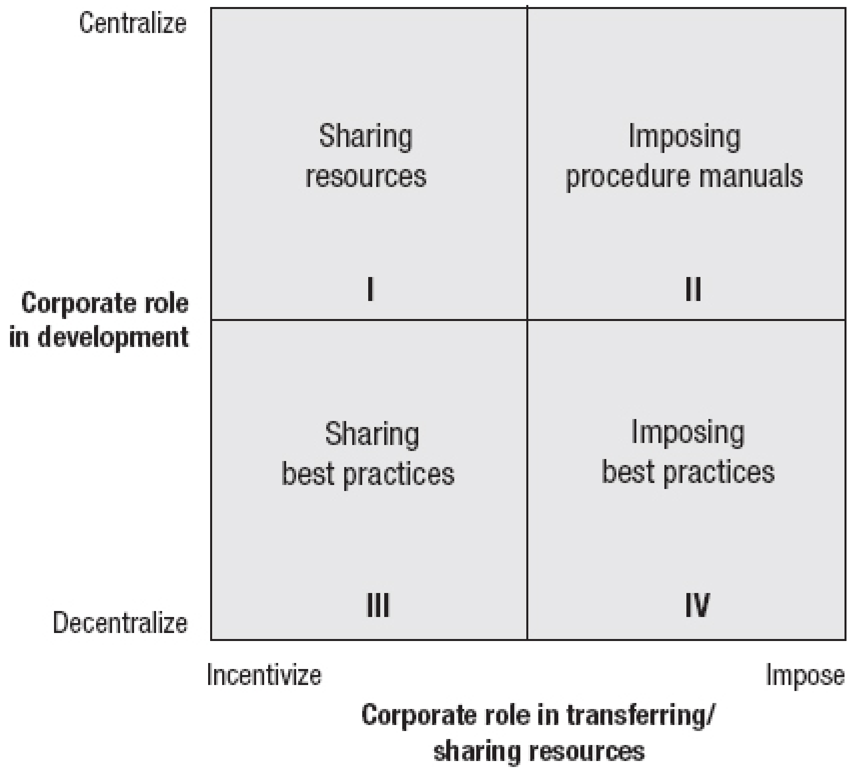
14.5 Prototypes of corporate headquarters' influence

Building and exploiting corporate valuable resources is of paramount importance for a multibusiness firm to strive for success, as described in Chapter 4 when we discussed the resources-based view. To further reflect on how this role can be performed, it is useful to consider two organizational dimensions:

- *The role of the corporate headquarters in developing resources*. The center can centralize or decentralize the development and nurturing of corporate resources.
- *The role of the corporate headquarters in sharing/transferring resources*. The center can stimulate or demand the use of a certain resource by divisions or subsidiaries.

By combining the two dimensions, we obtain a matrix as illustrated in Figure 14.1, which outlines four prototypes of corporate headquarters' influence which can coexist in a specific case.

Figure 14.1 **The transfer of resources**



Source: developed by author based on A. Campbell, K.S. Luchs, *Strategic Synergy*, Oxford, Butterworth Heinemann, 1992, p. 185.

The "Sharing resources" prototype (I) provides for corporate resources to be directly developed by the headquarters and for the relationship of sharing/transferring between this unit and the divisions or subsidiaries to be similar to the one between the supplier and a customer. Therefore, businesses have the power to buy or use corporate resources, but they are not required to do so. For example, UniCredit Group encouraged the use of the UniCredit brand in all of its divisions, without making it mandatory, like in the case of the asset management business, which maintained the Pioneer Investments brand for years. FCA Group developed various competence centers equipped with specific technical and engineering competences that offered services to the business units.

The "Imposing procedure manuals" prototype (II) provides for corporate resources to be directly developed by the headquarters and for the relationship of sharing/ transferring between this unit and the divisions and subsidiaries to be completely directive. This implies that the corporate headquarters has the power to allocate the resources among businesses and to choose how the resources must be employed by them. For example, the headquarters of Walt Disney or Virgin has centralized the management of corporate brands and has imposed their use by all business divisions and subsidiaries. Unichips Group (operating in the snack foods industry) has centralized the management of the distribution network made up of hundreds of vans that every day carry out sale and direct delivery of products of the two business units (savory and sweet products) in the tens of thousands of points of sale present in Italy (food retail channel and Ho.Re.Ca. channel).

The "Sharing best practices" prototype (III) provides for corporate resources to be developed by certain divisions or subsidiaries and for their exploitation by the other part of the organization to be simply stimulated or encouraged. In this prototype, business-level managers keep the power to make the final choice. For example, in luxury multibusiness firms, the management of the stylistic competences usually falls into Quadrant 3. The corporate headquarters can decide to make this resource available also to other brands, which however maintain their autonomy in deciding whether or not to use it to protect their stylistic identity.

Finally, the "Imposing best practices" prototype (IV) provides for corporate resources to be developed by certain divisions or subsidiaries and for their exploitation by the other part of the organization to be mandatory. For example, in the past the headquarters of FCA decided to impose the use of the engineering competences of Ferrari in the development of the Alfa Romeo business unit to recover a competitive edge.[16]

To incentivize the transfer or share of resources exploitation of resources, the corporate headquarters can:

- Develop personal relationships between corporate managers and business-level managers and between business-level managers (networking).
- Establish task forces and ad hoc committees with managers coming from the corporate headquarters and divisions and subsidiaries.

- Introduce managerial positions with a liaison role or an integration role (for instance, project managers).

Whereas, to exercise a directive influence on business divisions the main options are: the hierarchal accountability (centralization) and the definition of policies, rules, procedures, standards, or manuals.

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[1] This field of research includes scholars and practitioners who can be grouped in four "schools:" the economic, organizational, international business, and practice-oriented schools.

[2] Kunisch, Menz and Ambos (2015) and by Menz, Kunisch and Collis (2013).

[3] On group structures, see also Puranam and Vanneste (2016), pp. 191-93.

[4] For a detailed analysis of business groups, with particular reference to more recently industrialized countries, see Ramachandran, Manikandan and Pant (2013).

[5] For a discussion of the issue of portfolio strategy models, see Chapter 1.

[6] According to another contribution, it is possible to identify three roles of the corporate headquarters: "1. Performing obligatory company functions […]; 2. Providing the firm's operating units with centralized services […]; and 3. Value creation," Menz, Kunisch and Collis (2015).

[7] Zimmermann et al. (2013).

[8] Young et al. (2000).

[9] Collis, Young and Goold (2008).

[10] Bloom, Sadun and Van Reenen (2012).

[11] Kunisch, Muller-Stewens and Campbell (2014).

[12] Kruhler, Pidun and Rubner (2012).

[13] Puranam and Vanneste (2016) propose another model to study the influence of corporate headquarters based on two critical dimensions: stand alone vs. linkage influence, and the evaluative vs. directive influence.

[14] Campbell et al. (2014).

[15] Kruhler, Pidun and Rubner (2012).

[16] The example refers to the situation of the FCA Group's portfolio prior to the spin-off of the Ferrari business unit that took place in 2015.

15 The Organizational Macrostructures

by *Guido Corbetta*

15.1 Structural options

Organizational choices are part of the parenting strategy and contribute to defining the culture, organizational structure, operating systems, and processes of a multibusiness firm. The configuration of these elements usually evolves over time to maintain coherence with each other and with the portfolio strategy decisions the firm makes.[1]

Among organizational choices, those regarding the macrostructure are particularly important because they play a fundamental role in shaping the others as well.[2] Macrostructures (in brief, structures) are designed to facilitate the implementation of the strategic objectives of the company, identify the hierarchy of an organization, determine the way information flows within it, and fix how people behave in the workplace. The common structural options (or organizational macro-structures) are: horizontal or flat structure; functional structure (or Functional or F-form); divisional structure (or multi-division or M-form),[3] hybrid structure, and matrix structure.[4]

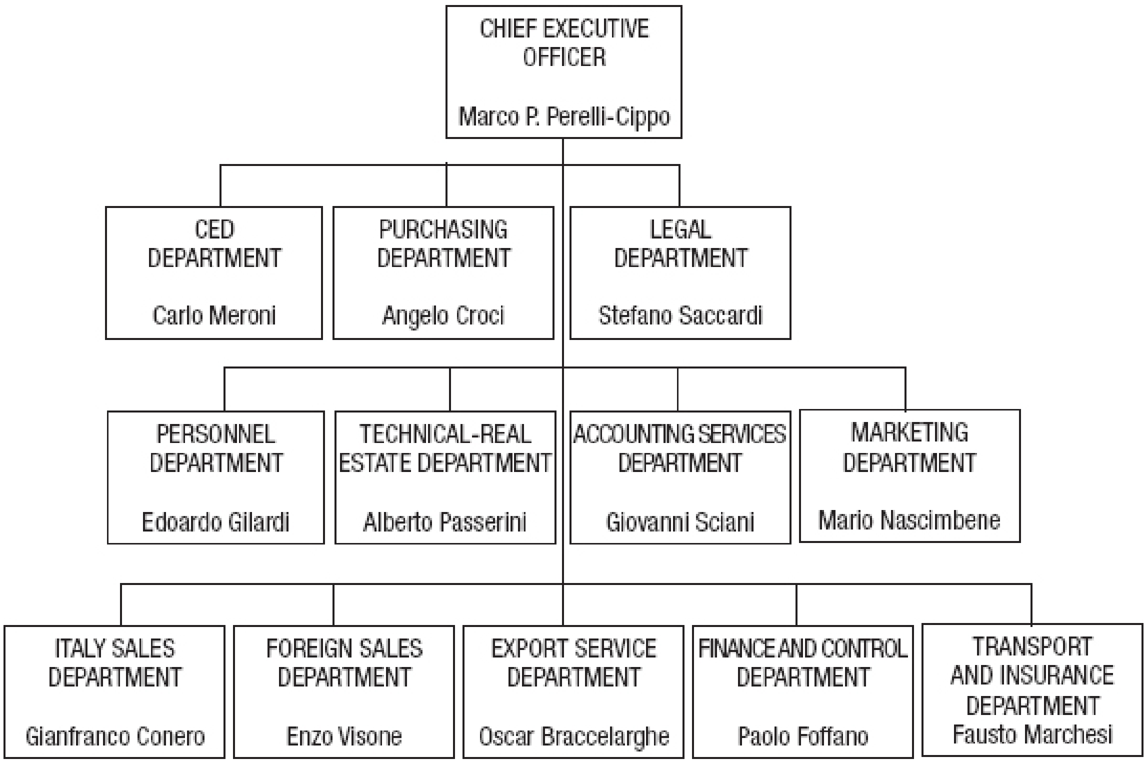
The development of structures follows a fairly codified path over time. Firms start their operations in a single business and usually opt for a horizontal structure with few or no levels of middle management. The few managers, therefore, report to the founder who plays the role of the Chief Executive Officer (CEO).

Upon going beyond the initial phase, firms normally adopt a functional structure in which some managers become responsible either for staff functions such as administration and human resource management, or for line functions such as purchasing, production, sales, and so forth.

In the next phase, some firms remain small for a long time and do not need to further modify their structure, which continues unchanged with a functional form.

Others are able to reach larger dimensions thanks to the implementation of a successful corporate strategy without having to change their structure. The functional form provides a high level of efficiency when the firm invests in just a few businesses whose value chains share many overlaps and similarities. For example, in 1993, Campari, which had revenues of around 250 million euros and a strategy focused on the Campari brand sold in only a few countries with a direct distribution channel, adopted a functional structure with twelve managers reporting directly to the CEO Marco Perelli-Cippo (Figure 15.1).[5]

Figure 15.1 The organizational macrostructure of Campari in 1993



Source: G. Corbetta, C. Salvato, *Red Passion: la strategia di espansione del Gruppo Campari*, Milan, Bocconi University, 2009.

When a firm chooses the functional form, it will not be possible to identify a corporate headquarters if we define it as "the organizational unit to which business divisions report." However, as we discussed in the previous chapter, the notion of corporate headquarters can be applied in these circumstances as well if some principles are taken into account.[6]

Once the firm has gone past the first phases of growth, the development of its organizational structure is differentiated depending on whether it adopts a synergy or a financial approach to corporate strategy.

15.2 Evolution of organizational structures (synergy approach)

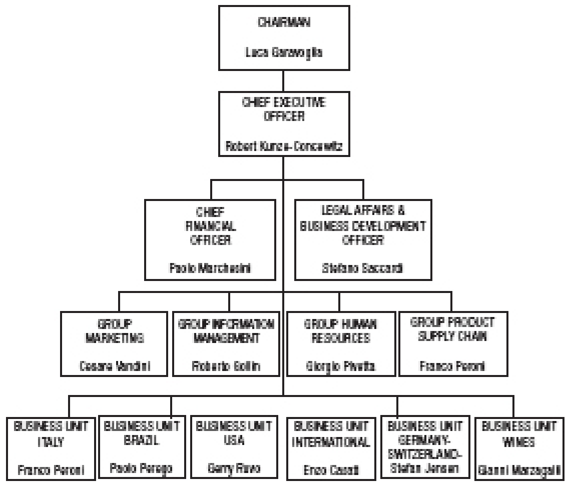
If the firm growth continues by gradually widening the corporate scope (for example, with the entry into new geographies or market segments), it becomes necessary to modify the structure to pursue goals of organizational efficiency and effectiveness jointly. This entails assigning to one or more executives or managers reporting to the CEO the responsibility for many or all of the decisions relating to one or more businesses. This evolution leads to a transformation of the structure from a functional form to a divisional one. In this way, it becomes possible to identify a corporate level (the CEO and the central functions) and a business level (the divisions). In each division, different functions are then performed in order to achieve business goals (generally, those dealing with operations and sales).

The key advantages of divisional structures are the following:

- Improving the degree of knowledge of the dynamics of each business because divisions operate more directly in contact with markets.
- Accelerating the decision-making because divisions can act more autonomously and quickly shift the direction of the business to respond to market changes.
- Increasing collaboration between the functions involved in a single division.
- Favoring the career pathways of competent managers, who feel motivated to be directly responsible for the results of a division.[7]
- Reducing the negative influence of the corporate headquarters.[8]

The evolution of organizational structure is exemplified by the case of Campari. In 2008, Campari had become a company with revenues of around one billion euros, that had grown with a synergy approach in many businesses and in diverse industries. Its structure was organized with twelve direct reporting lines to the CEO Robert Kunze-Concewitz. Of these, six were responsible for a central function, while six were responsible for businesses. Of the latter, five were responsible for the spirit and soft drink businesses in various countries and areas of the world (divisions specialized by geographies), and one was a division responsible for the wine business for the entire world (Figure 15.2).

Figure 15.2 **The organizational macrostructure of Campari in 2008**



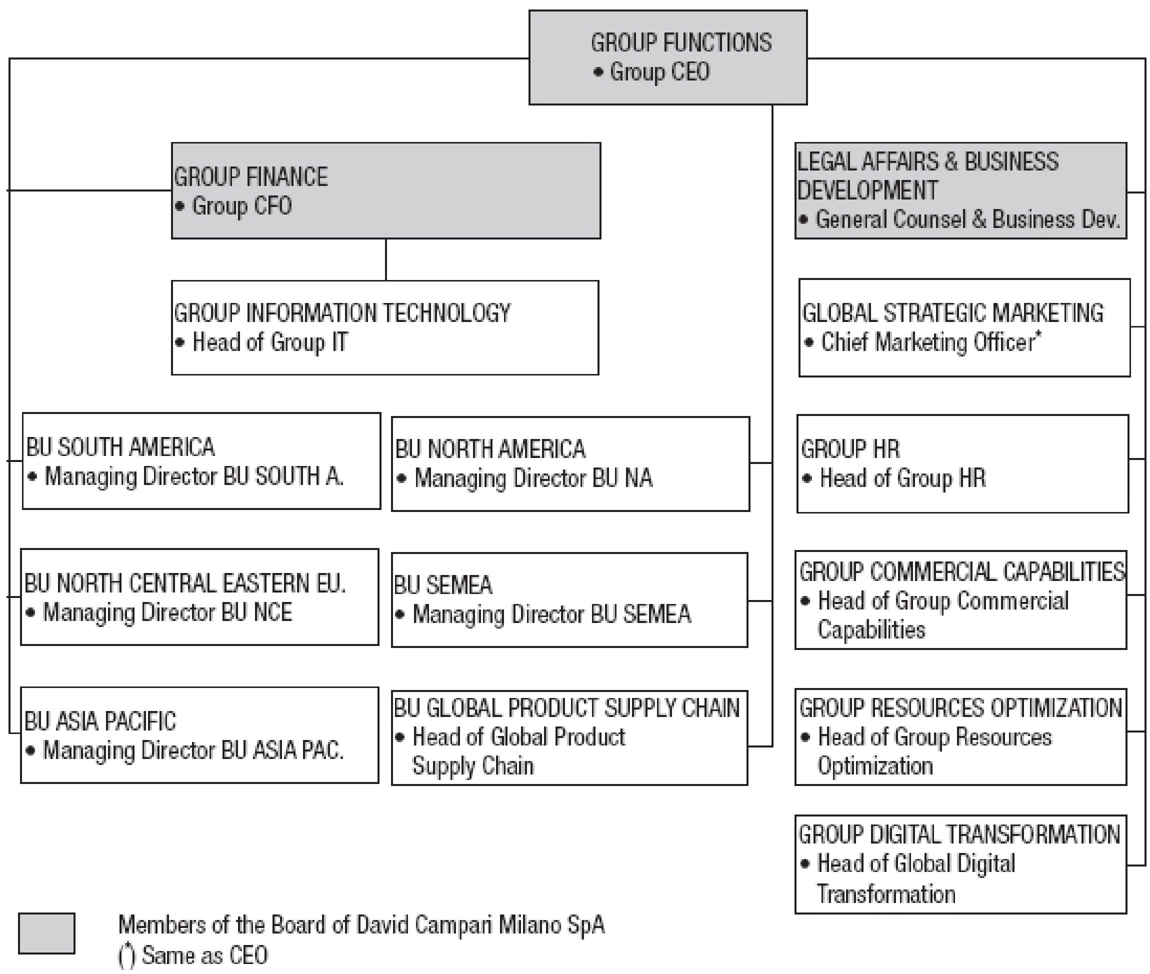
Source: G. Corbetta, C. Salvato, *Red Passion: la strategia di espansione del Gruppo Campari*, Milan, Bocconi University, 2009.

Organizational structures can further evolve after having reached a divisional structure. Unless there are strong signs of weakening of the corporate strategy, those changes take place over time periods that are not short. The main reasons for new changes depend on the sale or acquisition of new businesses. But they can also be ascribed to:

- The sale or acquisition of new businesses.
- The growth of a single business or the increase of the number of businesses in the portfolio.
- The request for new coordination needs between businesses that, for example, arise due to a technological innovation.
- The desire to revise the organization to overcome inefficiencies.
- The demand for a higher degree of decentralization of decision-making and delegation.
- The need to expand (or reduce) the responsibilities of one or more managers to retain him/her (or dismiss him/her).
- The desire of a new CEO to “mark” his/her leadership by launching an organizational change.

The importance of a continuous renewal of structures to preserve an internal coherence in the organization and an alignment with external dynamics can still be captured by analyzing the Campari case. In 2016, the group's structure presented new features as shown in Figure 15.3.

Figure 15.3 The organizational macrostructure of Campari in 2016



Source: G. Corbetta, C. Salvato, *Integrating Brands, People, and Passion: The M&A Capabilities of Gruppo Campari*, Milan, Bocconi University, 2017.

Fourteen units reported to the CEO: eight heads of functions (functional managers) and six heads of businesses (business unit managers).

Compared to 2008, the head of the wine business was no longer included because in the meantime the still wine business was sold while the sparkling wine business had been grouped with that of spirits, to be run through the divisions specialized by geographies. The accountability of these units was also modified. While in 2008 some were responsible for single countries (Italy, U.S., Brazil, Germany, Switzerland), in 2016 these units covered a broader geographical scope: South Europe Middle East & Africa (SEMEA), North America, South America, North Central Eastern Europe, and Asia Pacific. The new design made it possible to decentralize management responsibilities and minimize coordination costs and to cope with the extraordinary expansion of Campari which had invested in a greater number of countries over the years to achieve revenues in excess of 1.7 billion euros in 2016. Among those reporting directly to the CEO, a new division was then created: the Global Product Supply Chain (in 2008, this unit was a central function). That unit was responsible for procurement, manufacturing and logistics activities globally. This choice made geographic divisions accountable purely for local sales performance because it left them control only over local distribution platforms and on marketing and sales activities. With regards to central functions, three new units were added: Group Commercial Capabilities, Group Resources Optimization, and Group Digital Transformation.

15.3 Evolution of organizational structures (financial approach)

In firms growing with a financial approach,[9] upon entering the first unrelated business, the following occurs:

- The pre-existing structure is not changed significantly because there are not important operational synergies with the new business added.
- The organizational unit dedicated to the new business tends to become a division with varying degrees of autonomy.
- Corporate functions are created. Generally, these are the functional units existing prior to the decision to diversify, which begin to spend part of their resources to deal with corporate strategy decisions.

Over time and due to the growth in the number of unrelated investments, firms with a financial approach to corporate strategy tend to adopt the legal and organizational structure of business groups, with a holding company that controls a certain number of subsidiaries benefitting from a high level of autonomy.[10]

By way of example, consider the case of the Italian group Tenacta, headquartered near Bergamo, which at the end of 2015 had a turnover of approximately 150 million euros and was present in six different businesses:

- Personal care, with products such as hair dryers, electric razors, hair straighteners, sold with the Imetec brand in the consumer market and with the Collexia brand in the professional market.
- Winter products, with various types of heating products, from electric heaters to electric blankets. This business also included Scaldasonno, a revolutionary product used to warm beds launched at the beginning of the 1970s as a market breakthrough.
- Kitchen appliances, such as toasters, hot plates, blenders, mixers, and many other items.
- Steam irons.
- Vacuum cleaners and electric brooms.
- Coffee, that includes the sale of coffee and coffee machines with the Caravaggio brand through its own retail chain.

While the first five businesses were linked together by strong operational synergies (in particular in manufacturing, marketing and sales activities), the coffee business was organized as an autonomous division from the others. This division, developed as a part of an unrelated diversification strategy in 2008, had many strategic differences compared to the other businesses, such as in distribution channels (mainly retailing) and in the market target (consumers or end users instead of the wholesale market). Because of the launch of the coffee business, the Tenacta group decided to create a small corporate headquarters focused primarily on monitoring the performance of each business.

Even when the entry into a new and unrelated business takes place through acquisitions, the organizational structures of the acquirer and of the acquired firm do not undergo significant changes during the post-integration phase, as described in Chapter 10.

15.4 Relationships between the corporate headquarters and business units

The evolution from a functional to a divisional structure impacts on the relationships between corporate headquarters and business units as exemplified by the following two case studies.

In Campari, for example, this process first entailed the creation of a large corporate headquarters, and then a gradual reduction of its size to the benefit of geographic divisions. At the beginning the newly formed business units were rather lean and included only reporting lines in sales, and at times in production; while the corporate headquarters consisted of structured central functions such as human resources management or accounting, serving the multiple business units. As the business gradually grew, several new functional departments were then added within the geographic divisions. In some cases, these departments had also a functional reporting relationship with corporate headquarters. Therefore, the business units acquired more and more centrality in the organization over time with the effect of reducing the size and role of the corporate headquarters, which progressively decentralized responsibilities.

A different pathway has been followed by other companies such as the Fontana group, one of the global leaders in the fasteners industry, which competed only in Europe with a functional organization until 2014. In that year, the group made an important acquisition in the United States, buying Acumen, which had a size comparable to those of the European operations. Acumen operated in the same market segments as the Fontana group with a functional organization, and became an independent subsidiary after the acquisition, directly reporting to the CEO. In 2016, the European operations were reorganized as a geographic division with the appointment of a CEO Europe. This change marked a clear distinction of two levels in the organization: the corporate headquarters and the business units (Europe and America). The corporate headquarters took on the following responsibilities: consolidated financial statements, sales coordination (for large automotive clients operating both in Europe and in America), research and development, plant development, treasury, and legal and tax services. In 2017, the process entered a new phase. The American unit was split into two independent units, North America and South America.

The cases describe different developments in the relationship between corporate headquarters and businesses. Such developments underline the importance of the design of corporate headquarters as suggested by prominent scholars such as Campbell et al.:

> This raises the issue of what headquarters should do and how it will add value to the business divisions. It also raises the issue of how much autonomy business divisions will have.[11]

When the presence of a corporate headquarters and business units are consolidated, two opposite models of relationships between them can manifest in practice:

- A CEO to whom some rather lean central functions (i.e., characterized by a very limited staff that carries out only a few activities) and some highly structured business units report.
- A CEO to whom highly structured central functions and some lean business units report.

The first model provides for high autonomy of the single business units and has some advantages:[12]

- A high degree of accountability of each business unit towards the corporate headquarters.
- A higher level of entrepreneurship within single business units with the possibility to motivate their managers with entrepreneurial skills.
- Limitations or optimization of overhead costs because there are no duplications of functions between the corporate and business level.

This model is usually adopted by firms with a financial approach to corporate strategy. However, despite the presence of some advantages, it is scarcely widespread in practice as reported by the Boston Consulting Group study mentioned in Chapter 14. Less than 20 percent of a sample of multibusiness firms adopt the Financial Sponsorship or the Hands-Off

Ownership approach in designing and managing the corporate headquarters.[13]

As for the second model, it is more frequent in firms with a synergy approach to corporate strategy, and has a different mix of undisputed advantages, since the corporate headquarters can:

- Better coordinate the strategies of businesses and exploit significant operational synergies to create value.
- Exercise a pervasive control over business units by carefully setting and monitoring performance targets.
- Enforce adherence to a firm's goals and policies to prevent some business level managers from leading divisions as personal fiefdoms or without taking into account the firm's overall interest.

The choice of positioning within the continuum of the two opposite models depends on many factors, including the management style of the CEO and cultural elements of the organization. For example, some firms believe that having stronger control over business units through central structures is of paramount importance. In other firms, however, the positive value assigned to entrepreneurship is so felt that they prefer to give each business unit significant autonomy.

The choice can also depend on another very important variable: the geographic scope of the firm. If the business units are geographically dispersed, the size of the corporate headquarters tends to be more limited because it is difficult to impose policies and standards in very different and far-off geographic contexts.

To conclude, we can list some key points in dealing with structural options and, more in general, with organizational choices, confirming the importance of adopting a contingency approach in this field:[14]

- No perfect model exists: each has advantages and disadvantages.
- No permanent model exists: each model must evolve over time to take into account the changes in the corporate strategy and in the external context. It is also necessary to have the capacity to modify the model proactively, overcoming the inevitable resistance that will arise.
- Each firm must find its own path: it is useful to have some benchmarks, but they cannot be completely imitated. Each firm has its

own strategy to implement.

- Leadership skills and styles are important: it is necessary to find coherence between the skills and styles of the leadership and management team and the model to be adopted. When such coherence is not present, it becomes necessary to change the model or make some people decisions which may even entail the replacement of one or more managers not suitable for working in a certain model.

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[1] For a discussion that is still relevant today, see Coda (1973).

[2] Puranam and Vanneste (2016).

[3] Multi-divisional structures can be specialized by geographies, markets, products.

[4] For a discussion of organizational macrostructures, see Perrone (1990), ch. 17. In this book, we will not examine the theme of matrix structures because they are adopted only by large and broadly diversified multinationals.

[5] Another case similar to that of Campari (but different in terms of dimensions and sectors involved) is Apple, reported in ch. 12 of Campbell et al. (2014).

[6] Campbell et al. (2014), p. 239.

[7] Consider that in some cases, those managers could leave the company if they were not promoted to those positions; and consider also that the future Group CEO could be identified from among the heads of the business units.

[8] On the negative impact of corporate headquarters, see Chapter 14.

[9] See Grinblatt and Titman (2002).

[10] Here, we refer to changes in structure. Despite not modifying the structure, there can be a decision to change the heads of the various units.

[11] Campbell et al. (2014), p. 257.

[12] *Ibid*.

[13] See Chapter 14.

[14] For some of those conclusions, see Puranam and Vanneste (2016), pp. 189-91.

16 Leadership Models

by *Guido Corbetta*

16.1 The need for leadership

Given that in democratic culture we can speak of leadership only in the presence of free decisions of persons to avoid the risk of falling into more or less pronounced forms of authoritarianism,[1] firms need one or more people with leadership skills to be exercised. These people are "persons with certain motives and purposes [who mobilize] institutional, political, psychological, and other resources so as to arouse, engage, and satisfy the motives of followers."[2] According to another definition:

> [a] leader is an individual who significantly affects the thoughts, feelings, or behaviors of a significant number of individuals. […] Leaders present a dynamic perspective to their followers; not just a headline or snapshot, but a drama that unfolds over time, in which they – leaders and followers – are the principal characters or heroes.[3]

The need for leadership is strictly linked to the presence of followers in a company, persons who need someone who is able to dynamically present and satisfy their legitimate aspirations in order to best perform their work. This need also depends on to the fact that firms must periodically review and innovate their corporate or competitive strategy and the design of their organization. In these transitions, all of the people, organized into groups, are engaged in a process of incremental or radical change that must be guided by individuals with leadership skills. In the absence of needs for change, the relationships between people could take place following a traditional boss-subordinate one, that would considerably limit the need for leadership, despite the presence of a need for management.[4]

Leadership and management thus indicate different roles:

> Leadership is about coping with change: setting direction, aligning people, and motivating and inspiring. Management is about coping with complexity: planning and budgeting, organizing and staffing, controlling, and problem solving.[5]

In small companies, the low number of people limits the need for leadership to one or a few individuals; whereas in medium and large companies, this need gradually expands due to the growth in size and scope of the organization. In fact, growing and diversified companies organize themselves into different groups of people led by someone who interprets the expectations of other members, who motivates them to be committed, and who holds (or is appointed to) the position of leadership to produce a collective result.

The larger the organization is, the greater the need for leadership to involve the intermediate levels and not only the higher ones. According to this interpretation, leadership is a system instead of the simple reflection of the actions of an individual. In this system, we also include the contribution provided by the Board of Directors. Notably, this governance body is led by a chairman who plays a distinct leadership role along with that of the CEO.

16.2 Leadership and the role of the CEO

In both literature and practice, when speaking of leadership the reference is often to the Chief Executive Officer (CEO), although as noted above, there can be many people who must play the role of leaders of others in each company. It is true, however, that the CEO has a role and influence that is unique. Without John Sculley or Steve Jobs, the history of Apple would have been different; without Sergio Marchionne, the Fiat-Chrysler merger would not have succeeded; without Kenneth Lay, perhaps Enron would not have become one of the worst recent cases of mismanagement in the United States, and so on.

The CEO, his or her ambitions, values, and mental models, and those of his or her closest collaborators, have a decisive role in strategic decision-making and in the implementation of managerial actions aimed at modifying that strategy over time.[6] The key tasks of the CEO as a leader are precisely the definition and communication of the vision of development and strategic positioning of the firm, the choice of actions to make the positioning work, and the creation of systemic coherence between all activities performed by the firm, including the design of the organization. The role of the CEO can be neither limited to nor confused with "an activity of orchestration of operational improvements and compromise solutions."[7]

From a traditional perspective, which should definitely be dropped, CEOs are heroes who make all the key decisions. Two prominent researchers criticize the vision of the solitary hero as follows:

> The Lone Ranger, the incarnation of the individual problem solver, is dead. In his place, we have a new model for creative achievements: the Great Group. Great Groups don't exist without great leaders, but they are much more than lengthened shadows of them.[8]

A great modern leader, Sergio Marchionne, used similar words in his first speech to all Chrysler employees on June 10, 2009, after the entry of FCA into the capital of the large North American company:

> The era of the Great Man, of a greater-than-life individual who, working alone, cures all the ills of an organization, is dead. The Great Man has been replaced by Great Groups.[9]

In modern organizations – oriented towards empowerment and continuous learning[10] – the role of leaders is thus more complex than that of the "solitary hero," and simultaneously includes three facets:[11]

- *Designer* of cohesive social organizations founded on shared visions, ambitious long-term strategic goals, and choices of people suitable to achieve the strategies set out.
- *Teacher* able to help others and themselves develop the learning skills necessary to achieve a more penetrating interpretation of reality, being able to codify not only events and behavior, but also the underlying systematic structures.
- *Steward* of people and organizations concerned more with the common good than their own success, and capable of defining sets of values that guide organizational behavior.

Many great leaders have tried to define their roles in leading large companies. For instance, the leader of Red Hat, the promoter of the open organization, defines his role as a modern leader as follows:

> My job is not about conjuring up brilliant strategies and making people work harder. What I need to do is create the context for Red Hat associates so they can do their best work. My goal is to get people to believe in the mission and then create the right structures that empower them to achieve what once might have been impossible.[12]

And Sergio Marchionne summarized his thinking on the role of the leader this way:

> The only two rights I have as CEO are to choose the people to work with and the values that drive the company.[13]

A similar view is stressed also by Bennis and O'Toole. Building on an analysis of the mistakes that a Board of Directors can make when it chooses the CEO, they stress the importance of avoiding candidates "who pose as leaders" and rather concentrate on those who have demonstrated their ability to develop leaders from among their collaborators.[14]

16.3 The traits and skills of leaders

Studying the phenomenon of leadership (exercised by CEOs, but also, as we have seen, by other collaborators) means analyzing the character and behavior of the leader, his followers, and the context in which leadership is shown. The trait theory of personality is given less weight by scholars today, but in reality it is foolish to pretend that such characteristics don't count at all. While we can certainly find people who are positioned along a continuum that goes from the total absence to the fullest and most convincing form of leadership, an examination of numerous cases allows us to see that leaders are distinguished by certain elements: moral integrity, intelligence (practical, theoretical, and above all emotional), long-term orientation, passion for their work, natural dynamism driven by positive energy, the ability to inspire others, the ability to make decisions in an uncertain context, tenacity (that sometimes can lead to harsh behavior with themselves and towards their collaborators with the aim of reaching goals), patience, and flexibility (which leads them to recognize their mistakes and change direction when needed).[15]

For decades, researchers have produced classifications of leaders and leadership. We will describe three of them here with increasing degrees of analysis.

16.3.1 A traditional interpretation

According to a traditional interpretation that is still very much centered on the role of the CEO, the various traits cited above (and others as well), mixed with different doses, give rise to different types of leaders. For reasons of brevity, here we will only present one possible classification based on the different sources of authority on which leaders can draw:

- The *positional leader*, for whom the source of authority is represented above all by the position held in the organization.
- The *charismatic leader*, who is able to assert himself/herself due to his/her natural personality.
- The *reputational leader*, for whom the source of authority is mainly linked to results reached in the past.
- The *knowledge leader*, who knows the relevant contents in a certain situation better than anyone else.

- The *servant leader*, who is able to motivate followers to give their best, in the collective interest.

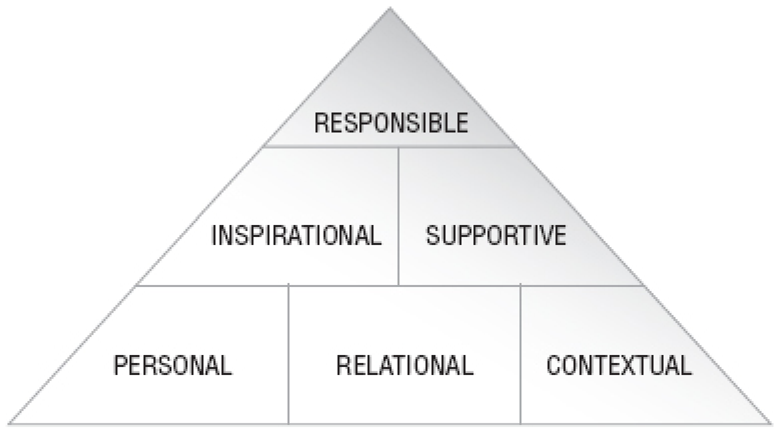
16.3.2 The Sitkin and Lind method

Considering above all (but not only) the role of the CEO, Sitkin and Lind (2006) concentrated on the areas or domains of leadership that each leader can possess according to different levels of intensity.[16] They thus identify six relevant domains of leadership (Figure 16.1), which can be detailed as follows:

- *Personal leadership* (showing personality, character and identity) based on authenticity, expertise, creativity and innovation, convincing vision, dedication to the team, and fit with the team in terms of their values, so as to have credibility to lead.
- *Relational leadership* (showing concern and understanding) based on concern for others, respect regardless of one's position in the hierarchy, comprehension of the needs and capabilities of others, and fair treatment of followers, so as to earn their trust.
- *Contextual leadership* (building an organization identity and clarifying the purpose) based on giving meaning to the team's or organization's efforts, providing coherence to the task and the environment, and helping followers focus on what is really important for success, so as to create a sense of community.
- *Inspirational leadership* (ability to motivate others) based on encouraging the adoption of ambitious goals, instilling authentic enthusiasm and optimism, and promoting innovation, so as to inspire high aspirations.
- *Supportive leadership* (ability to support others by providing feedback and protection) based on instilling a sense of efficacy in the organization, creating a sense of security and protection to show that the leader will take care of followers, working hard to prevent an atmosphere of blaming, and understanding failure, so as to promote the sense of initiative of followers.
- *Responsible leadership* (ability to spread a sense of responsibility and to be a model of ethics) based on balancing competing interests, taking

responsibility for ethical behavior, and taking on the public role of leadership, so as to lead followers to take on their own roles of stewardship.

Figure 16.1 The Leadership Pyramid



Source: S.B. Sitkin, E.A. Lind, *The Six Domains of Leadership: A New Model for Developing and Assessing Leadership Qualities*, Chapel Hill, Delta Leadership, Inc., 2016. Reprinted by permission.

16.3.3 The FCA model

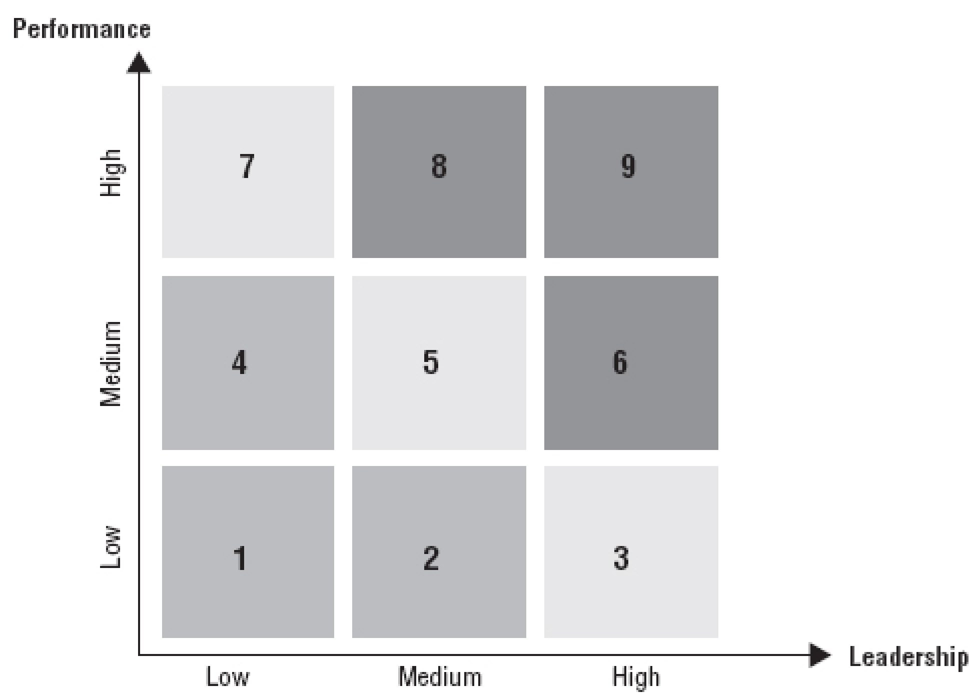
Because in modern organizations leadership is a system that must spread at every level of the structure, it is important to adopt a series of tools to assess the leadership capacity of collaborators, not only of the CEO. The experience of Fiat Chrysler Automobiles can be useful for this purpose. The group classifies 16 leadership skills divided into two large areas:

- *Leading Change*, it can be summarized as the ability to embrace and cherish competition, reach for discontinuity, have energy to achieve results, deliver change as a way of life, act quickly and decisively, and act with integrity.
- *Leading People*, it can be summarized as the ability to coach people beyond what they believe possible, give them freedom to act, build

only the best teams and develop leaders, and treat people with dignity and fairness.[17]

Building on the assessment of leadership skills and the evaluation of individual performance, collaborators are positioned in one of 9 quadrants of the Performance Leadership Matrix (PLM). Quadrants 1, 2, and 4 identify people who do not meet the expectations of the managers who evaluate them; quadrants 3, 5, and 7 identify people who meet the expectations; and quadrants 6, 8, and 9 identify people who exceed the expectations the managers had for them (Figure 16.2).

Figure 16.2 The Performance Leadership Matrix



Source: developed by author based on R. Kaplan, B. Bertoldi, *Sergio Marchionne at Chrysler*, Harvard Business School, Case 9-415-045, 2015.

It is worth noting that leadership can be exercised in different contexts, that must be properly taken into account either by the leaders to tweak their style, or by those who have the responsibility of selecting and appointing a new leader.

One of the key factors impacting on the context is the different mix of followers. They can be classified as: external observers, fanatics, and acolytes. The first group follows the leader despite not being particularly convinced; the second, for various reasons, shares what has been proposed by the leader; and the third represents the group of persons who participate in the leader's convictions. Generally, the different types of followers are simultaneously present in each situation, but the prevalence of one over the other generates a different need for leadership.

Then the configuration and possible evolution of the business and environmental contexts both have an impact on the need for leadership. An important distinction is that between contexts that require drastic interventions and rapid course changes, and situations in which a more gradual approach to change is suitable.

Lastly, the degree of external visibility required by the company's situation also impacts leadership choices. In a context such as a listing, leadership should be able to build visibility and reputation externally. Differently, a firm may need a more internally focused leader when it is under reorganization.

16.4 The collective nature of leadership

Although the debate about leadership is mainly focused on the role of the CEO, there are many cases of co-leadership (or collective leadership) at the top of firms of any size that are able to achieve extraordinary performance. Co-leadership is understood here as a leadership system in which two or more people work together toward shared goals and take the responsibility to lead a firm collectively. In Italy, for example, about 40 percent of all family businesses with revenues exceeding 20 million euros are led by at least two leaders who play the role of Chairman and CEO.[18] The phenomenon is widespread in many other geographies including North America.

The success of the co-leadership model largely depends on the combination of the qualities and personal traits of each leader. Indeed, if such a combination is well balanced, it can produce a more effective system than one with a single leader. The main conditions that a collective leadership system must meet to deliver good performance are the following:

- *Full awareness of the nature and implications of the model*, namely in terms of sharing of rights, responsibilities, and decisions among the leaders involved.
- *Personal characteristics of the members of the team*, complementarity of characters and skills, equal commitment and orientation to excellence, respect, trust, and mutual esteem.
- *Structure of the team*, clear division of responsibilities with the appointment of a *primus inter pares* who performs a role of coordination, not command.
- *Effective team working*, being used to working as a group, co-responsibility for strategic decisions, "common front" towards collaborators (to avoid showing them internal divisions in the team), clear mechanisms of communication to favor effective coordination within the team, and between the team and other actors.
- *Firm's characteristics*, existence of clear mechanisms of integration, well-functioning corporate governance, and sustainable competitive advantage.
- *Constant monitoring of the previous conditions* and where necessary, timely interventions for correction.

16.5 Negative leadership

Under the impetus of very negative events in the history of some large companies, a field of research has emerged to investigate cases of negative leadership.[19] A leader is negative when he is distinguished by a relatively high degree of incompetence or ineffectiveness and/or due to a relatively lack of ethical behavior.[20] An ineffective leader is not able to produce the desired change. An unethical leader is not able to distinguish between right and wrong, places his or her own needs above those of the followers, does not have personal virtues such as courage or temperance, and does not act for the common good.

By combining these two elements (ineffective leadership and unethical leadership), we can identify six types of negative leadership:[21]

- *Incompetent leadership*. The leader and at least some followers lack the will and/or skill necessary to continuously carry out effective actions. They do not create positive change.
- *Rigid leadership*. The leader and at least some followers are stiff and unyielding. Despite being competent, they cannot or do not want to adapt to new ideas, new information, or the changing times. They refuse to be "defeated by the facts."[22]
- *Intemperate leadership*. The leader lacks self-control and is supported and favored by followers who do not want to or cannot intervene effectively. The current period marked by the strong power of media accentuates the difficulty of maintaining behavior oriented towards temperance.
- *Callous leadership*. The leader and at least some followers are cynical or even only unkind. The needs, wishes, and desires of almost all the members of the group or the organization, especially subordinates, are ignored or relegated to the background.
- *Corrupt leadership.* The leader and at least some followers lie and cheat. They put their interests above public interests and manipulate consent. In extreme cases, they take actions that are against the law.
- *Insular leadership*. The leader and at least some followers minimize or disregard the health and welfare of the others, those who live outside of the group or the organization for which they are directly responsible.

Focusing attention on the incompetent leader, a recent contribution brought into focus some of its recurring manifestations that can produce very negative results. They are the following:[23]

- Errors in choosing collaborators and difficulty in deciding what to do with ineffective collaborators. There can be various reasons for this, including: "intellectual seduction" exercised by the collaborator, consolidated and at times too much friendly relationships, excessive confidence in the leader's ability to coach, good reputation of the collaborator with some important stakeholders, fear of the reactions of the Board of Directors regarding the umpteenth removal of a collaborator, and fear of having to hire someone from outside of the organization.

- A consulting approach to leading that encourages the leader to focus more on the formulation phase and less on the execution phase in managing a firm. In some cases, that approach is the temporary consequence of prior experiences in consulting which the leader has a difficultly abandoning, but in other cases, it is an insurmountable hurdle due to a lower or lack of interest towards execution.
- Inability to concentrate on continuous improvement of the firm's performance and an exclusive focus on corporate finance transactions. The motivation for that phenomenon is often found in the greater visibility and (presumed) greater rapidity of financial returns linked to extraordinary finance operations.
- Excessive commitments outside of the company that distract focus and energy from managing change and getting things done, for instance serving as a member of several Boards of Directors of other companies, multiple commitments in associations, and so forth.

Negative leadership, which always represents a threat even for the most successful leaders, can be overcome with a system of rules that creates a context in which it is more difficult to adopt unethical behavior and with an incentive mechanism that rewards followers who assume the responsibility to support positive leaders and penalize negative leaders. Those followers are characterized by loyalty to the institution in which they operate, more than to single persons, the courage to make decisions requiring leaders to answer for their actions, and a good degree of skepticism.

Finally, to prevent forms of negative leadership, much work must be done on the educational and training system so that it nurtures leaders who maintain constant contact with reality, preserve personal equilibrium, self-consciousness and self-control, exercise caution towards media exposure, hire strong and independent board members, and encourage dissent and pluralism.

[1] "In our culture, popular understanding of the leadership process distinguishes it from coercion – and places those forms involving the least coercion higher on the scale of leadership." Gardner (1986), p. 2.

[2] Burns (1978), p. 18.

[3] Gardner and Laskin (1995), pp. 9, 14.

[4] On the subject of changes in corporate strategy, see Chapter 17.

[5] Kotter (1996).

[6] Coda and Mollona (2002).

[7] Porter (2005), p. 27.

[8] Bennis and Ward Biederman (2007), p. 109

[9] Kaplan and Bertoldi (2015).

[10] Senge (1990).

[11] Greenleaf (1977).

[12] Whitehurst (2016), p. 36.

[13] Kaplan and Bertoldi (2015).

[14] Bennis and O'Toole (2000).

[15] Some of the characteristics cited are drawn from Whitehurst (2016), pp. 204-205. A recent study identified some characteristics of CEOs that can be included in those cited: "deciding with speed and conviction, engaging for impact, adapting proactively, delivering reliably." Botelho et al. (2017).

[16] Sitkin and Lind (2006).

[17] Kaplan and Bertoldi (2015).

[18] AUB (2016).

[19] Kellerman (2005).

[20] On the subject of incompetence, Dematté (2001) thoroughly analyzed the negative consequences for an organization of the inability of a leader to adjust their leadership style to changes in the relevant context. On the subject of ethics, Coda (2005) presents the consequences of different conceptions regarding corporate social responsibility.

[21] Kellerman (2005) proposes seven types of negative leadership, but the last ("evil") characterized by atrocities is not widespread in businesses.

[22] Tuchman (1984), p. 7.

[23] Charan and Colvin (1999).

17 Strategic and Organizational Change

by *Guido Corbetta*

17.1 The causes of change

Sooner or later, all firms must face the need for a strategic and/or organizational change (in brief, change). Change becomes urgent when signs of weakening of the corporate strategy emerge, and obviously, signs of weakening are easier to recognize when they worsen financial performance. But good leaders are able to recognize such signals before they have a severe impact on financial statements, in order to introduce changes even in the presence of satisfactory results, and to prevent or avoid the impact of transformational trends still latent, but imminent.

From the perspective of corporate strategy, firms typically change in response to internal and external causes, which are often interwoven with each other. Each of those causes can be connected to one of the four logics for making corporate strategy decisions (business logic, added value logic, capital markets logic, governance and compliance logic).[1]

External causes of change include:

- *Reduction of the attractiveness in the industry in which the firm operates (business logic)*:
  - *A shift in customer or client preferences*. The spread of the habit of wearing sportswear in the workplace has reduced the attractiveness of the men's formalwear industry's segment.
  - *An increase of competition*. The construction of many ships for maritime transport of goods by shipping companies has significantly reduced the industry's profitability.

- _ *A new technological development*. The spread of the electric engine is raising serious questions about the future attractiveness of many segments in the automotive component industry; above all, those who are still very dependent on a massive use of internal combustion engines by automotive manufactures.
  - *An institutional or regulatory change*. The decision by many countries to invest in renewable energy, such as solar or wind power, has reduced the attractiveness of the thermoelectric and nuclear energy industries.
- *Factors reducing the value of corporate resources (added value logic) or business resources (business logic)*:[2]
  - *Imitation by one or more competitors*. The M&A competence of Bacardi-Martini lost value over years due to the ability of a rival such as Campari to develop a similar competence through the execution of several M&A transactions of equal or even greater value.
  - *Strategic innovation by one or more competitors*. The online retailing of luxury products launched by newcomers such as YOOX has considerably weakened the value of the retail networks of many luxury companies.

Whereas, internal causes comprehend:

- *Excessive price of acquisitions or excessive investment to overcome entry barriers to a new business (capital markets logic)*. The entry of RCS into the Spanish publishing market in 2007 was carried out with the acquisition of Recoletos, which was overpaid. This choice amplified prior strategic and financial problems at RCS, that was ultimately taken over by the Cairo Group in 2016 (one of its competitors in the Italian market), to then be successfully restructured.
- *Entry into a new business without the resources to successfully compete (added value logic)*. The entry of the Benetton group into the world of technical-sports clothing exemplifies this situation. The group thought it was possible to use the product design skills and production and distribution assets that had allowed it to achieve a competitive advantage in the casual clothing industry, to succeed in the new business. Within a few years though, it realized that those

resources were entirely inadequate, both because technical products required much more specific design and production skills, and because the sales channels for those products were entirely different from those usually adopted by Benetton up to that point. This mistake led then to the sale of the technical-sports clothing business.[3]

- *Ineffective corporate governance or inadequate leadership (governance and compliance logic)*. In the 1990s, Sitia Yomo became the leading company in the production of yogurt in Italy. Upon the death of the chairwoman Renata Vesely, the family decided to name the two children as heads of the company, who unfortunately did not prove to be sufficiently prepared for the position. In 2004, the company was saved from bankruptcy only thanks to acquisition by the Granarolo group.
- *Fraud (governance and compliance logic)*. In the Italian banking sector, various players experienced irreversible crises in recent years due to the misconduct of some managers who were then punished by the judicial authorities.

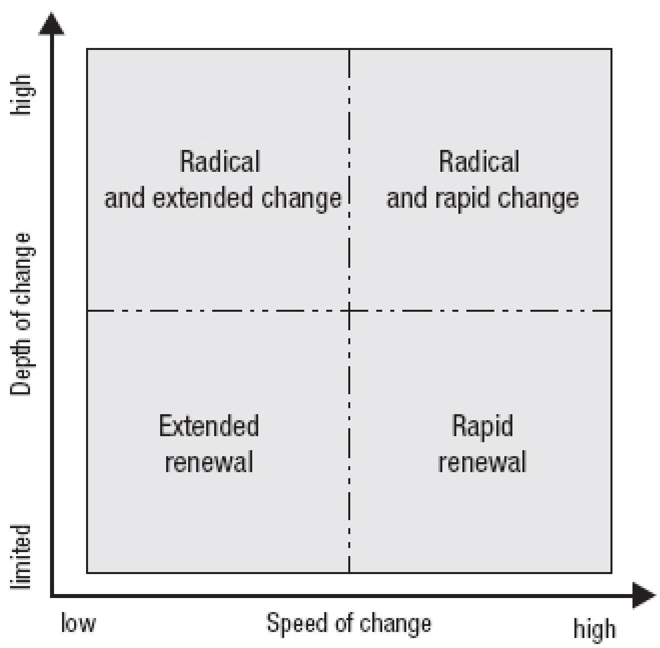
17.2 The types of change

There can be various types of changes depending on the perception of signs that the shareholders or leaders develop in regard to the gravity of their causes and the level of urgency to face the challenge of change. Figure 17.1 provides a classification:

- *Radical and rapid change,* serious and urgent signs provide the impetus for the most radical intervention possible in the shortest time possible. An economic or financial crisis of the company due to one of the causes cited above leads to this type of change.
- *Radical and extended change,* serious signs can also be accompanied by less urgency for change, because their manifestation is still in the potential state. Given that the development of the electric car will force a radical change in the automotive value chain, today many firms still believe that such a change can be faced in the medium to long-term.

- *Rapid renewal*, the signs can also indicate a lesser need for radical change, but shareholders and leaders prefer to proceed rapidly to make changes in order to seize the benefits in the shortest possible time. At the end of the 1990s, Bocconi University decided to accelerate the process of renewal of its corporate strategy, despite the substantial absence of any signs of weakening of that strategy.
- *Extended renewal,* signs of weakening of corporate strategy can combine with less pressing times for intervention. This category includes many cases of renewal that can be managed gradually over time.

Figure 17.1 Types of change



Turning to the more radical changes of corporate strategy, they manifest themselves with:

- *Profound changes in the portfolio strategy*: these changes translate into the exit from one or more businesses or the entry into one or more new businesses.

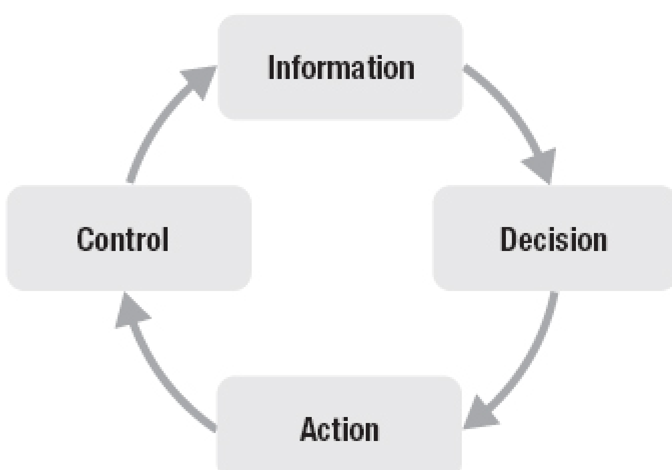
- *Profound changes in one or more elements of the parenting strategy with reference to the structure and functioning of corporate headquarters*: the replacement of the leader, the replacement of other important managers, and the renewal of the Board of Directors.
- *Profound changes in one or more elements of the parenting strategy affecting the organization of businesses controlled by the corporate headquarters*: the replacement of the leader, the replacement of other important managers, or the redesign of the organizational macrostructure.

The other type of change, i.e., renewal, consists of a partial modification of the portfolio (increase or decrease of the weight of each business within the portfolio) or of minor revisions to the parenting strategy.

17.3 The process of change

The change of a corporate strategy (and of any other type of strategy in general) can take place according to a sequence of phases as illustrated in Figure 17.2, which is divided into: *information, decision, action*, and *control*.[4]

Figure 17.2 The phases of the process of change



17.3.1 Information

To make a change, it is necessary to start with an in-depth understanding of the internal and external causes that motivate it, in order to set the future strategic direction. The search for information is a process consisting of certain steps such as the definition of information to seek and of sources to scrutinize, the definition of the methods of research, the research itself, and of the organization of the information gathered.

The role of the leader (of the corporate headquarters or the businesses) in this process is to push all collaborators to develop genuine curiosity regarding the situation. This means encouraging them to observe everything surrounding the company, to "come out of their shell," to "see beyond their own horizons." Within the organization, it is also necessary to have the desire to look for information and data, making an effort to apply non-traditional interpretations and discover in the organization the people who possess relevant information, whose visibility is often limited by their direct superiors.

The process of searching for information is so crucial to then identify the correct choices, that it should be tackled with indomitable energy without settling for the initial results, because often, as a great French entrepreneur once wrote, "reality is hidden in the facts like metal is hidden in the mineral."[5]

This process significantly improves if within the corporate headquarters and between the latter and the heads of businesses, a transparent, regular, two-way flow of information is established, based on data and facts. A flow of communications of this type benefits from:

- Identifying an organizational model so that the manager of the corporate headquarters and the businesses can present the results of the information gathered with the appropriate depth.
- Building of trust relationships between the people so that each of them feels comfortable presenting data, information and also their judgments, and responding to doubts and objections.

An interesting example of the process of searching for information was introduced by the Dean Angelo Provasoli in 2004 when it was time to define the changes for the Bocconi University.[6] For the first time, a Dean's

Committee was created to discuss and approve most operating decisions for Bocconi. This committee included the Dean of Bocconi, the Deputy Deans for Research, Human Resources, and Internationalization, and the Associate Deans of the five Schools (Undergraduate, Graduate, Law, PhD, and SDA School of Management). The Committee met each week, assigning to each member the responsibility to gather the initial information for each important issue, asking everyone to have an open attitude and to give and receive comments, including criticism, going beyond their natural reluctance to do so. This was an indispensable step to set up an effective process of gathering and evaluating information.

This way of working together was also shared by a great leader of our time, Steve Jobs, who with a certain level of brutality, wrote:

> That's the ante for being in the room: You've got to be able to be super honest. Maybe there's a better way, a gentlemen's club where we all wear ties and speak in this Brahmin language and velvet code-words, but I don't know that way.[7]

And the leader of Red Hat – a software company with over 7,000 employees listed on Wall Street and part of the Standard & Poor's 500 – who convincingly proposed the model of the open organization, writes:

> People need a thick skin to deal with the extensive and often relentless feedback involved in working the way we do at Red Hat. It takes time, effort, and a good dose of humility—especially if you're the CEO—in order to build such a culture.[8]

Concerning the search for information, we observe that sometimes leaders and managers confuse it with a sort of confirmation of their vision change. This represents a serious mistake, because their vision could be wrong. Good management mean maintaining intellectual honesty and respect the reality of facts, more than one's preconceived ideas.

17.3.2 Decision

Information is needed to make decisions, but they cannot substitute human judgment in the process of change, which always comes with inherent risk.

The information gathered must be processed based on a strategic hypothesis of change. As two prominent scholars in business management used to say, it is necessary to develop "sufficient knowledge of the phenomena of companies and the market"[9] and to properly insert the information into an "entrepreneurial formula, in which various elements of the organization come into play."[10] Without the capacity to organize the information within a vision of change, there is a risk of wasting a lot of time in useless analysis or to make incoherent decisions.

That said, at a certain point, it becomes very important for the governance bodies, leaders, and management to move on to the decision phase (and then action) without lingering on the search for information. This is a delicate step that is described as follows by a successful Italian entrepreneur:

> After you have gathered all of the data and information necessary, the time comes in which you have to make the decision. It is a moment in which your ability to manage individual tension is sorely tried. For my part, after I have asked if I have conducted all of the analysis possible "to the best of my knowledge and belief," I take a period of individual reflection and then I decide. After I have made the decision, I feel as if I have taken a weight off that could have crushed me.[11]

17.3.3 Action

Action is the result of a decision that entails the development of not only a specific intellectual ability, but also a solid character that allows for overcoming the natural fear every woman and man has when faced with difficult choices. This aspect of character is even more important in cases where radical change is sought.

Given that in a complex organization it is necessary to involve at least all of the top levels of management in the action phase, if not even broader parts of the organization, the most important choice to be made by the leader consists of the identification of the direct collaborators to whom to entrust the responsibility for the change actions. This choice, which requires courage and organizational sensitivity, must be based on two elements:

1. *The variety of contributions*, attempting to construct teams of people with uniform values, but with complementary ideas and skills.
2. *Meritocracy*, i.e., a system of values that promotes excellence independent of a manager's origin – in terms of family, ethnicity, culture, or other traits – promoting and giving responsibility to those who have the greatest probability of achieving change.[12] Without a culture based on merit, nepotism takes hold, leading to unsuitable or incapable managers (in terms of competences and character) in positions of responsibility, provoking a vicious circle, with negative consequences for the process of change.[13]

In the case of the Bocconi University, Dean Provasoli had the courage to appoint to the Dean's Committee a new generation of professors in their forties, who to that point had no significant roles in the management of the University.

Other important actions are those that directly allow leaders to motivate employees to embrace change with optimism. Those actions can be successful if the leader possesses certain skills, such as the ability to:

- Summarize the essence of the change with only a few simple words, whose explanatory force is comprehensible and reasonable for anyone.
- Convincingly transmit his or her confidence in the plan for proposed change, focusing on the positive elements of the proposal and avoiding putting emphasis on the negative ones, despite pointing them out.
- Give sense and meaning to the efforts linked to each process of growth and change.[14]
- Address all collaborators and outside interlocutors with humility, so as to avoid seeking any adulatory behavior that always, ultimately, indicates weakness of leadership.[15]

After having defined the guidelines and some preliminary actions to be carried out, Dean Provasoli decided to organize the first meeting of the entire faculty (about 300 people) outside of the formal location of the Faculty Council. That meeting, strongly desired and the result of long preparations, was one of the actions that most contributed to changing the Bocconi University, because it gave Provasoli a way to present to everyone the meaning and essential contents of the change and forced every member of the faculty to "bring themselves into play" personally, regardless of the role they held in the University. Another example is the semi-annual meetings with the students, during which Provasoli asked all of the members of the Dean's Committee to transmit the sense and state of progress of the change underway to the University's most important stakeholders.

17.3.4 Control

The evaluation of an action for change must be based on the results achieved, and not only on good intentions. Sometimes, behind bad results there can be good intentions, but what counts are the consequences of the actions, and not only the intentions that led to them.

Therefore, each action requires constant control to determine if the results meet expectations. As a consequence, it is necessary to activate a system of performance management. At times, especially in successful organizations, adequate work is not done to implement a good system of this nature, because as Claudio Dematté wrote, "the success obtained by the firm produces a strong sense of arrogance and a blunting of the ability to be critical."[16]

In Provasoli's experience as Dean, what immediately comes to mind is the work performed by the entire Dean's Committee to adopt a *tableau de bord* that allowed for collecting, monitoring and evaluating the results of the Schools, Departments, and research centers. The process required months of work to be completed because the committee was aware that the set of measurements would be a decisive tool to stimulate the most appropriate behavior and determine if the organization was moving in the right direction.

A good performance measurement system always highlights areas for improvement of the process of change. In some cases, it allows for stressing partial or temporary failures. If recognized promptly, these can become the source of new actions that lead to new cases of success. Of course, in these circumstances, it is important to have the moral strength, the energy, and the tenacity "to pick up the pieces and start again." In addition, leaders and the organizations they lead should make a commitment to a process of "continuing learning by doing,"[17] to call into question previous decisions and actions in order to choose how to move forward and thrive.

With regards to the phase of control, it is important to distinguish carefully between the quality of perseverance and the defect of obstinacy. When faced with problems, it is not useful to pursue at all costs the direction undertaken to demonstrate one's leadership. Rather, it is advisable to quickly dig into the causes of the problems (for example, an error made or an unanticipated change in the environment), seek a solution, and if one is not found, to move as rapidly as possible to accept the loss suffered and change direction.

17.4 Resistance to change

> There are a number of erroneous assumptions that most economically-oriented strategy researchers continue to borrow from economics. At this moment those that are clearest are plasticity, rationality of collective actions, and homogeneity of beliefs. I believe that the most important of these is plasticity – the assumption that firms readily respond to exogenous shocks and changes […]. Yet the truth is that firms change only with difficulty […]. I call this lack of plasticity inertia.[18]

These words by Rumelt allow us to introduce the concept of resistance to change (or barriers to change). People (and firms) do not change naturally or immediately. Even when faced with events that should unquestionably suggest changes, resistance can arise due to four factors: (i) a distorted perception or a delay in the perception of the changes underway, (ii) lack of sufficient motivation to change, (iii) difficulty in defining the possible response to change, and (iv) the existence of forces that prevent the implementation of the change.[19]

With regard to the distorted perception or the delay in perception of change, it can depend on certain elements:

- The leader and the management are short-sighted, they don't see the need for change, or they fail to act because they rationally disbelieve the statements of their collaborators or subordinates about the long-term. Ghemawat calls this myopia negligence and stresses that we can expect that greater room for negligence will occur for firms with greater success. "Put simply, diets richer in fat lead to a hardening of the arteries of the organization."[20]
- The leader and the management recognize the need for change but deny the evidence, for reasons such as pride in past accomplishments (this is why many processes of change require the replacement of various managers and even the leader as well) and fear of the new.
- The leader and some managers do not deny the evidence of the need for change, but then a series of routines lead them to comply with group thinking that does not consider change as necessary.[21]

Once the first obstacle has been removed, organizations may still resist change due to a lack of sufficient motivation. In multibusiness firms, this can happen because change entails:

- Direct costs for the leader or the management as a result of disruption in operations and the risk of organizational failure.
- Cannibalization of the activities for which they are responsible.
- Rethinking of the cross-subsidizing system between divisions and/or businesses.

On the subject of cannibalization, in many countries there is a tendency to wait for the environmental dynamics to be recognized by other competitors first, deciding to develop a strategy to respond only subsequently. Despite understanding that prudent attitude, experience suggests to firms to be ready to cannibalize their own products, resources, or businesses if the environmental dynamics demonstrate that it is indispensable to do so. If they entrench themselves in their position, firms will not only fail to explore the potential benefits of cannibalization, but they could also never be ready to effectively react to the attacks received by rivals or newcomers.

The third element of resistance, difficulty in defining the possible response to change, manifests itself when the leader and the management are unable to take actions to change because:

- They are not able to interpret a complex decision situation or to cope with things happening too fast.
- They believe that in reality the problems regard the context and nothing can be done to change them ("the industry is mature," "Asian competitors benefit from favorable conditions," and so forth).
- They have an inadequate vision or sense of direction to lead the firm or they are not well equipped to craft a new corporate strategy.

If the leader and the management have seen the need for change and have prepared a response, various types of resistance can still show up in the implementation phase, due to:

- Political deadlocks, the proposed change triggers resistance from groups of power within the organization that combat the new direction every way possible, sometimes for reasons that are not even fully clear.
- Blocks linked to the inability of the leader to construct a system of actions (and incentives) that neutralize resistance and reward those that commit to change.

In the previous section, we have already outlined a series of considerations that help prevent these types of resistance. We can add that an important role lies with the corporate headquarters, which should:

- Carry out periodic and honest monitoring of performance.[22]
- Dedicate constant and respectful attention to the conduct of the best competitors.[23]
- Maintain a listening attitude without prejudice to understanding the needs and expectations of all stakeholders.[24]
- Involve new people with different skills and attitudes who can provide their contribution to transforming firms.[25]

All of this should favor a prompt perception of the development underway and should allow for identifying the direction of a possible change.

Finally, to strengthen the motivation for change and facilitate its implementation, it is decisive to create a sense of urgency in the organization.[26] In firms more capable of addressing change periodically, there is often a climate of moderate perennial dissatisfaction: good results reached seem to be soon forgotten, people are continuously stimulated to make big or small improvements in their activities, and competitors are always cited due to what they know how to do best. In all other firms, a sense of urgency can be instilled in the organization through an early warning system and, sometimes, even by replacing the leader and at least part of the top management team.

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[1] For a discussion of those logics, see Chapter 1.

[2] For a discussion of the issue of corporate resources, see Chapter 4.

[3] Colli (2017).

[4] The model proposed has some similarities to that created by John Boyd, a colonel in the US Air Force, entitled OODA (Observe, Orient, Decide, Act). Boyd originally conceived of OODA to describe the process that a fighter pilot must follow to win an air battle. See Whitehurst (2016).

[5] Michelin (2002).

[6] Gavetti and Canato (2008).

[7] Isaacson (2011), p. 569.

[8] Whitehurst (2016), p. 36.

[9] Zappa (1957), t. I, p. 100.

[10] Coda (1988), p. 93.

[11] Corbetta (2005), p. 32.

[12] Abravanel (2008).

[13] On the need for meritocracy in companies that wish to continue to transform themselves in order to face change, see the fourth chapter of Whitehurst's book, suggestively entitled: "Choosing meritocracy, not democracy": Whitehurst (2016), pp. 103 ff.

[14] On this subject, see also Vitale in the preface to the Italian version of Finkelstein (2004); Lansberg (1999).

[15] Collins (2005).

[16] Dematté (2004), p. 23.

[17] See Coda (1988); Norman (1977).

[18] Rumelt (1995), p. 103.

[19] On the importance of perceptions in processes of change, see *ibid*.

[20] Ghemawat (1993), p. 109.

[21] Group thinking is the process where people, when they work in a group, tend to seek harmony and minimize conflict, often with negative results: on this subject, see Surowiecki (2005).

[22] "One of the crucial factors in becoming a learning organization is feedback, which is a prerequisite in the learning process": Beckard and Pritchard (1992), p. 19.

[23] An entrepreneur who is the leader of a champion of Made in Italy production says: "still today, when I am shown analyses of our competitors, it is natural for me not to dedicate any attention to those that have had inferior results, and to focus on the best ones, aiming to become like them."

[24] See Kotter (1996), pp. 182 ff.

[25] Ghemawat (1999) stresses that what counts is that a vigorous and frank debate developed between people with knowledge power and those with *organizational power*.

[26] Kotter (1996).

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